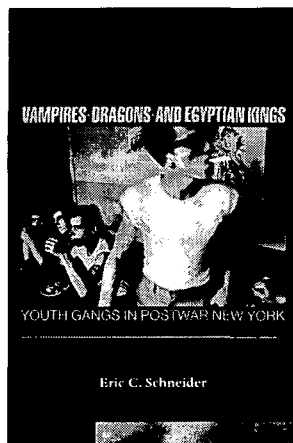


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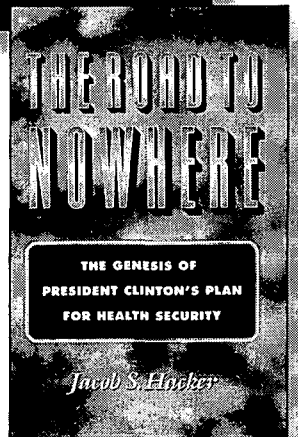


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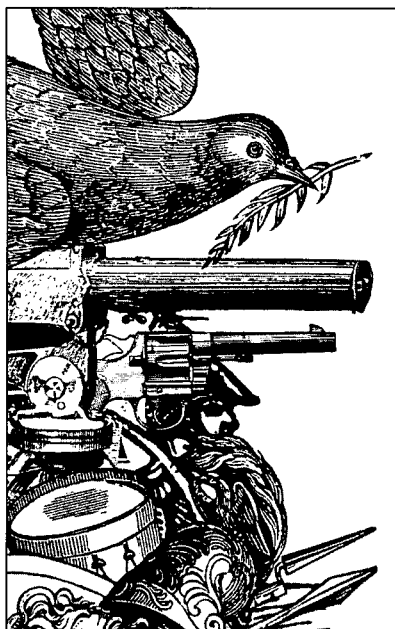
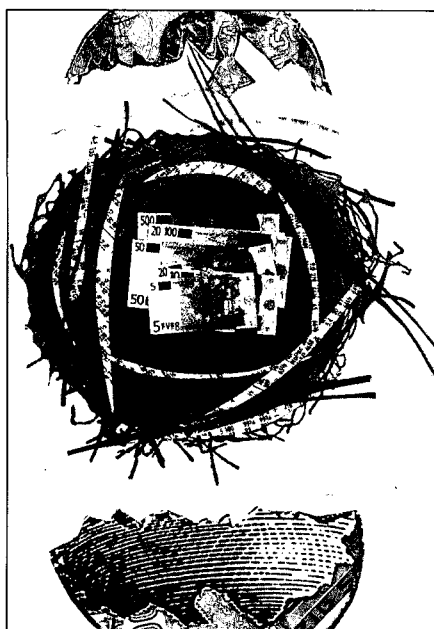
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SUMMER 1999 VOL. 17 NO. 3



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European Challenges for the United States

T

HE UNITED STATES has four fundamental strategic relationships—those with Europe, Russia, Japan, and China. This judgment remains as valid today as it was 60 years ago on the eve of World War II. A central task for senior U.S. policymakers is to concentrate attention on these key relationships and to prevent less significant problems—such as Haiti, Panama, Bosnia, Somalia, and now Kosovo—from dominating time and agendas.

Of the four strategic relationships none is more important for this country than Europe. Europe remains a critical arena for both American leadership and partnership. Moreover, Europe today is on the cusp of fundamental change with clear and immediate ramifications for the United States.

The United States has three objectives in Europe. The first is a Europe at peace and free of domination. The second is a strong, self-confident, integrated, and outward-looking Europe. And the third is a Europe that can act with the United States as a partner on a number of challenges with which none of us, acting alone, can cope—a Europe that, in partnership with the United States, will work to find solutions to global challenges and be a leading force for world progress.

To achieve these objectives the United States must continue to further the integration of Europe by strengthening such institutions as NATO, the European Union, and the Organization for Security and Cooperation in Europe. We must also continue to make the United States and Europe even stronger partners by deepen-

ing and energizing the already substantial consultative framework and by working to diminish growing European frustrations with perceived American unilateralism and American frustration with cumbersome European Union decisionmaking.

The United States and its European allies confront several important challenges: completing the construction of a democratic and peaceful Europe, finding a satisfactory peace in the Balkans, assuring that the expansion of European institutions eastward does not create a new divide between Russia and the West, and maintaining economic stability and promoting economic growth throughout Europe and the world.

Our common challenges do not end here. We must also confront numerous global problems, including the proliferation of weapons of mass destruction, international crime and terrorism, environmental threats, and refugee flows.

From the U.S. perspective, a critical issue is to keep NATO functioning as a force for stability and political reassurance for all the nations of Central and Eastern Europe and the Newly Independent States. Through its successful Partnership for Peace, the Alliance has brought 24 nations into training and education activities to increase civilian control of the military and expand responsibility in peacekeeping and crisis management. The recent enlargement of NATO to include three new members has been an important step in adjusting this institution to its new role in Europe.

NATO is engaged in an important humanitarian effort to return the Kosovo refugees to their homes and establish se-



Lee H. Hamilton served in the U.S. Congress for 34 years and is the director of the Woodrow Wilson International Center for Scholars in Washington, D.C.

by Lee H. Hamilton

*The United States has four fundamental strategic relationships—
with Europe, Russia, Japan, and China—and none is more
important for this country than Europe.*

curity in that province. But the United States and NATO must recognize that their approach does not offer a solution to the problem underlying this conflict—the future status of Kosovo—and that neither military action nor the proposed settlement addresses this core question.

The crisis in Kosovo has seriously strained unity within NATO and the transatlantic relationship. Kosovo is profoundly influencing Alliance debate on the new strategic concept and the advisability of out-of-area activity. What we should avoid, if at all possible, is an open-ended, long-term NATO commitment to the region—in the capacity of either an occupation force or a nation-builder—that will drain NATO's resources, attention, and energy away from its core functions. But regardless of the outcome in Kosovo, a dialogue on the future of the alliance is appropriate.

While the United States does not have a seat at the table for discussing internal European Union issues, a more efficient, integrated Europe, an enlarged European Union with effective decisionmaking, including an enhanced role for the European Parliament, is in the U.S. interest. So too would be reform of the EU budget so that less is spent to support a common agricultural program and more to advance a European Security and Defense Identity that will give Europe a defense capability to work in harmony with NATO.

Within this process of institutional reform, several economic issues are important to the United States. For Europe to become more competitive economically, it must reduce further the role of the state and foster decentralization in political and economic decisionmaking. At issue is in-

creased privatization of the banking industry and telecommunications, as well as significantly expanding the use of information technology. Such steps would help reduce high unemployment in much of Europe and allow all citizens to benefit from sound policies of economic and monetary union and a single market.

Trade issues will continue to be important. Today, trade disputes between the United States and Europe play too large and disruptive a role. Public policy discussions on both sides of the Atlantic devote excessive attention to hormones and meat, bananas, genetically altered food, and threats of sanctions. Both the United States and Europe need to develop better machinery for resisting protectionism and for placing trade policy in its appropriate priority within transatlantic relations.

The state of U.S. relations with Europe is solid, but it will be tested, and good ties cannot be taken for granted. Resolving the Kosovo crisis in a way that maintains the cohesion of the Atlantic Alliance and restores a working relationship with Russia is imperative. Building bridges that allow the United States to cooperate with European institutional reform and encourage Europe to do more on its own in security and defense are essential. We should also seek to expand trade and investment without allowing trade disputes to dominate our public and private exchanges. Most important, common interests require that leaders on both sides of the Atlantic continue to invest their time and energy in this crucial transatlantic relationship. Stability and prosperity, not simply in Europe but the world, depend on it. ■

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STEVE MCAFEE

EUROPE, at Century's End *The Challenge Ahead*

BY RICHARD N. HAASS

The year 1999 marks the end of the first decade of the post-Cold War world. For Europe, a region central to the Cold War—where it both began and ended—1999 is also proving to be a year of historic import, the most important on the continent since 1989, when the wall came down and Europe's division came to an abrupt and for the most part unanticipated end.

This claim can be justified by pointing to many events and trends, including the fitful progress toward reconciliation in Northern Ireland and Germany's emergence as a more "normal" country, one able to use military force beyond its borders as part of a nondefensive NATO action. Still, four developments in 1999 stand out: European Monetary Union and the launch of the euro; the entry of Poland, Hungary, and the Czech Republic into NATO and the articulation of a new strategic concept for the Alliance as it passed the half-century mark; the continuing deterioration of conditions within Russia and in U.S.-Russian relations; and the Kosovo conflict, the largest military clash on the continent since the Second World War.

Richard N. Haass, vice president and director of the Brookings Foreign Policy Studies program, is the author of The Reluctant Sheriff: The United States after the Cold War (Brookings, 1997) and editor of Transatlantic Tensions: The United States, Europe, and Problem States (Brookings, 1999).

Bearish on Russia

Russia is in many ways the most vexing, significant, and unexpected problem to cloud Europe's horizon. Russian weakness is proving a more complex challenge to Europe and the United States than did Soviet strength. The stakes are great, not so much in the economic sphere, where the actual or potential global impact is limited given Russia's small and increasingly barter-driven economy, but rather strategically, given Russia's ability to influence events in Europe through its political and military power and its nuclear arsenal.

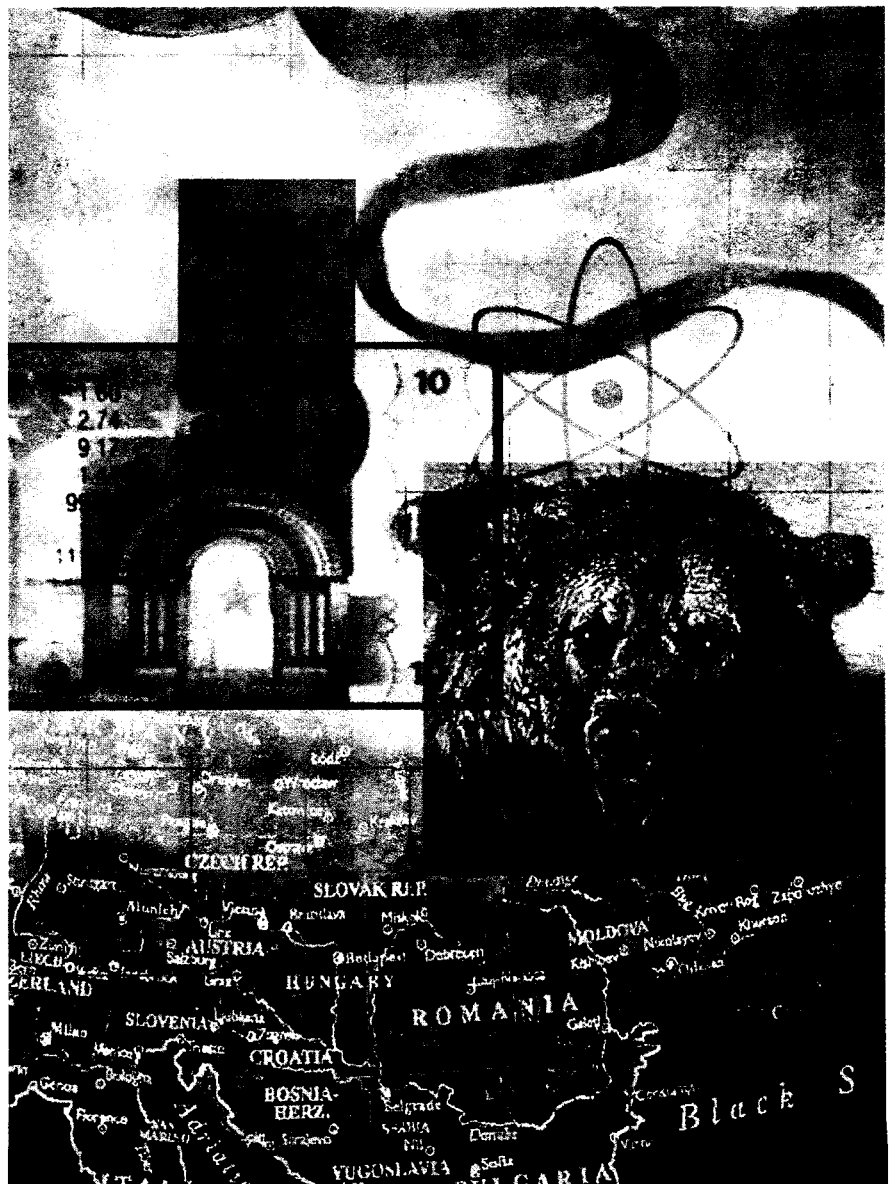
But Russia's economic situation has grave strategic implications. An economically weak Russia is much more likely to pose a strategic threat, be it through arms sales to problem countries, authorized (or unauthorized) provision of technology to the unconventional weapons programs of so-called rogue states, a greater reliance on nuclear weapons to offset a growing inferiority in conventional arms, and, most worrisome, a loss of control over its own nuclear arsenal.

There is no single answer to the challenge posed by a weak Russia. It is, however, possible to rule out some alleged answers that are clearly misguided, including neglect. Russia needs help from the outside, but only on a conditional basis. Conditionality is necessary if economic assistance is to gain the required political support within donor societies and if funds are to do anything more than enrich corrupt individuals within Russia. Among the other lessons of the past few years is that market economic reform cannot occur (much less be sustained) in a vacuum if it is to be something other than crony capitalism; basic infrastructure improvements—property rights, securi-

ties regulation, generally accepted accounting practices, bankruptcy proceedings, and so on—are essential.

All this will take time, though, something that does not square with the urgent challenges posed by Russia's enormous but unsafe nuclear arsenal. Bruce Blair and Clifford Gaddy suggest a range of measures, from the relatively modest—a U.S.-Russian accord to reduce the alert status of their weapons to lessen the chance of crisis instability, a cut in the number of deployed strategic nuclear systems to well below START II levels—to the ambitious, including a

grand bargain in which the United States and Europe would buy much of the Russian nuclear stockpile. The latter would be costly, but so would the alternatives—modernizing U.S. nuclear forces or building large defensive systems to protect against a Russian attack. Moreover, trading bombs for dollars would improve American and European security and bolster Russia's economy. Such thinking may be too “outside the box” for many, but it is hard to see where staying the course—and seeing conditions within Russia or in U.S.-Russian relations continue to worsen—would



The research on Europe and Russia was made possible by the German Marshall Fund of the United States, the Carnegie Corporation of New York, the John M. Olin Foundation, and the John D. and Catharine T. MacArthur Foundation.



Membership in Alliances



NEITHER





serve any American or European interest.

Working out a constructive relationship with Russia over the past decade has been complicated by differences over how best to promote peace and security throughout Europe. Until 1999, much of the disagreement centered on Western plans to enlarge NATO by offering membership to former members of the Warsaw Pact, among others.

These differences caused strains but not a breach in relations with Russia, as evidenced by Russian willingness to sign an agreement—the so-called Founding Act—that institutionalized NATO-Russian consultations. Russia's participation in the Bosnia peacekeeping effort was another sign that it was prepared to contribute to European security despite its unhappiness over NATO's growth.

Whether such a restrained “agreement to disagree” can continue if NATO enlargement proceeds is less

The United States cannot have it both ways, urging that Europe do more, but do America's bidding and no more.

clear. Bringing Russia into NATO at some point is an option, but one that would require the emergence of a very different Russia—and result in the emergence of a very different NATO. But regardless of whether Russia ever formally joins NATO, James Goodby is correct when he argues that European security will benefit directly and dramatically from a Russia that is democratic, prosperous, and stable—and not alienated from the United States and the countries of Western Europe. Avoiding such alienation, Goodby suggests, will require sensitivity and compromise on both sides: the West will have to keep Russian concerns in mind as it uses force in Europe and proceeds with NATO enlargement; Russia for its part must work with the United States and Europe in combating the proliferation of weapons of mass destruction, terrorism, and threats to innocent peoples from their governments. The only thing that is certain is that making Europe “whole and free”—not to mention peaceful and prosperous—promises to be a long-term, difficult proposition.

For the immediate future, James Goldgeier puts forward the logical and, to many, persuasive argument that it makes no sense to stop NATO enlargement now. To do so would only redraw the line dividing Europe and deny the

GLENN PIERCE

advantages of NATO membership to other deserving states. But further enlargement is hardly problem free. Beyond its economic costs and the risk that it would further complicate Alliance decisionmaking is the risk that adding Baltic states to the Alliance could trigger a crisis with Russia—and within Russia.

Alas, one need not wait for a decision on NATO enlargement to set off a crisis with Russia; the war in Kosovo has done that. Russians are unhappy and angry over the attacks on their fellow Slavs. That these attacks were carried out without UN Security Council authorization and by an enlarged NATO from which they are thus far excluded makes matters that much

of a unified Germany, and uncertainty over how Russia will evolve—but that a continued focus on defending against a nonexistent threat is not enough.

The principal alternative mission for NATO, as set forth by Ivo Daalder, is to broaden its mandate from combating external threats to countries within the treaty area to promoting peace and security throughout all of Europe. The change could come about in two ways: through continued enlargement and through taking on the sorts of challenges that developed in Bosnia and Kosovo.

When leaders of NATO's 19 member states convened in Washington last April, they agreed to such a new strategic concept. That they did so amidst the war in Kosovo, however, highlighted the gap

The Russian reaction to the NATO attacks on Yugoslavia is both deep and wide, reflecting widespread frustration in that country over its reduced circumstances at home and its reduced status abroad.

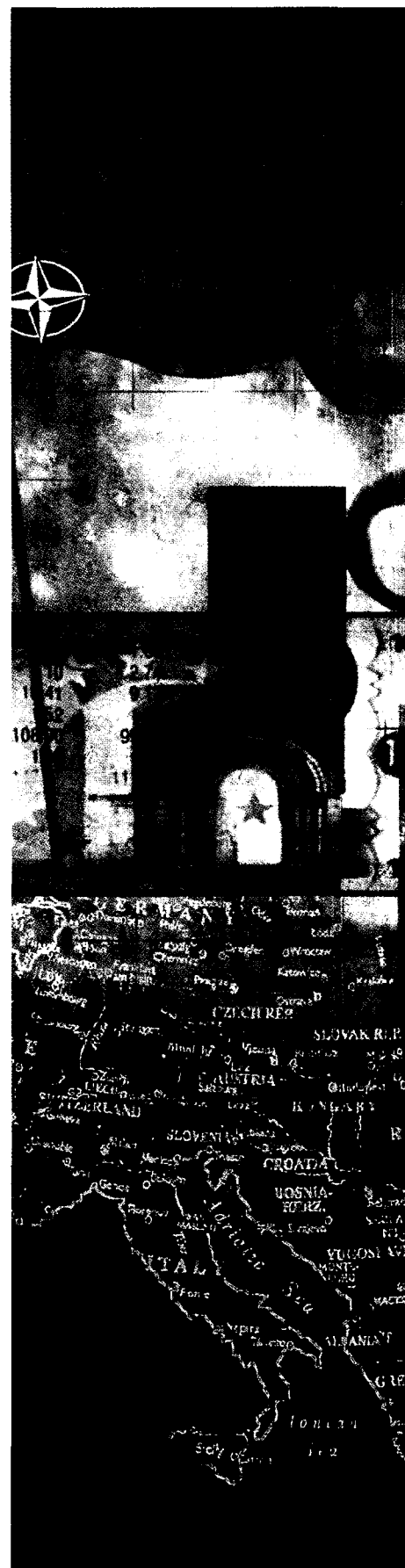
worse. The Russian reaction is both deep and wide, reflecting widespread frustration in that country over its reduced circumstances at home and its reduced status abroad.

The war in Kosovo is also a crisis for NATO. For the 40 years of the Cold War, NATO unity was forged around a common threat; under Article 5 of the NATO treaty, Alliance members pledged to defend one another against external attack. With the demise of the Soviet Union and the end of the Cold War, many analysts and politicians believe that NATO must evolve or risk fading away. They argue that NATO remains valuable—especially in keeping the United States involved in Europe's security, given the limits on what Europeans are able and willing to do in the defense realm, the potential primacy

between rhetoric and reality. It is one thing to talk about meeting challenges to European peace, quite another to do it. The risk for NATO is that the experience of Kosovo will jeopardize the Alliance's cohesion just at a time it is seeking to define a new purpose.

Economic Europe

Few if any observers predicted at the outset of 1999 that NATO would be the European or transatlantic institution that would most come under strain during the year. The European Union (EU) was the more obvious candidate. Indeed, the year began with the launch of the 11-member European Monetary Union and its common currency, the euro. This is the latest and one of the most important of the many steps Europe has taken toward integration



over the past half century—and, as Robert Solomon points out, the first time since the fall of the Roman Empire that much of Western Europe has had a single currency.

Creation of the euro effectively brings about a single European financial market, which should facilitate economic activity and, with it, growth. Still, the euro is not without its skeptics. Many question whether member governments can and will maintain the necessary fiscal discipline if they are faced with high unemployment or recession. The euro and EMU are the products of a continent that is increasingly controlled collectively in the economic sphere—while governments and politicians are still mostly elected in national and local contexts. Whether this tension can be managed remains to be seen.

On the American side of the Atlantic, there are those who doubt whether the euro is good for the United States. Some fear it will make Europe more of a closed market or weaken the role and value of the dollar. Others predict it will lead to greater European political and military unity—and greater independence from the United States. Elizabeth Pond takes a relatively sanguine view of these possibilities—but points out that the euro is likely to promote economic reform within Europe and make Europe more like America, benefiting some American investors and exporters but posing severe hardships for others who lose out to new competitors. As the U.S.-European skirmish over bananas indicates, trade frictions and protectionist pressures are never less than dormant and can surface with a vengeance, bearing adverse consequences for transatlantic political and economic relations.

In trade as in other matters, it is obvious that the United States and Europe, though drawn together in many ways, do not always or automatically see eye to eye. One specific disagreement involves Turkey, a country the EU has kept at arm's length for a host of reasons,

including dissatisfaction with Turkey's handling of its Kurdish problem and human rights more generally, tensions between Turkey and EU member Greece, and concern that Turkish entry into the EU could have adverse consequences for agricultural policy and labor markets. The United States has for the most part taken a more sympathetic approach to Turkey, a country viewed as vital not only for its contributions to European security but also for its links to the greater Middle East. As Heinz Kramer explains, bridging these transatlantic differences will require new flexibility in European thinking—and internal reform in Turkey itself, something that its domestic politics threaten to make more not less difficult.

The Way Ahead

The challenges facing Europe in 1999 and beyond are enormous. Indeed, the agenda could hardly be more crowded or daunting: Kosovo and the broader problem of bringing stability to the former Yugoslavia; ensuring the success of EMU; enlarging and deepening both the EU and NATO; and promoting Russian democracy, economic revival, and integration with the rest of the continent.

Many of these challenges are as much transatlantic as European in nature and will require close collaboration between the United States and Europe—whether as individual states, within NATO, within the EU, or within some other forum. Consultations using all these frameworks will remain essential—and would be more useful if Europe begins to speak with one voice on matters of security. Also useful would be a transatlantic commitment to open trade, to meet the norms and adhere to the decisions of the World Trade Organization; trade can be a source of prosperity or discord but not both.

But consultation and even compromise will not be sufficient. For the transatlantic tie to work and for Europe to prosper, Europeans must be prepared to assume a greater share of the burden

of action, especially in the military domain. They must be ready not just to spend somewhat more on their military capacity, but to spend it on forces that are relevant for the post-Cold War world rather than its predecessor. Europeans will need, too, to resist the temptation to oppose American leadership simply out of resentment.

At the same time, the United States will have to accept that a greater European willingness and capacity to share the burdens of European and global security will translate into enhanced European influence, especially if Europe is prepared to act politically and militarily under EU rather than NATO auspices. The United States cannot have it both ways, urging that Europe do more, but do America's bidding and no more. In addition, the United States will need to curb its enthusiasm for economic sanctions in general and for secondary sanctions—those imposed on countries (often European) who do not support U.S. sanctions against such countries as Iran, Libya, or Cuba—in particular.

But whatever the specific changes and compromises, it is critical that the two sides get it right. Europe and the United States remain essential to one another. It is not simply a matter of economics, although transatlantic trade and investment count for a lot. Nor is it simply a shared interest in Europe's stability, although this too obviously matters a great deal to both Europeans and Americans. Rather, it is that both Americans and Europeans have a major stake in what sort of a world emerges in the aftermath of the Cold War. Their ability to help bring about a world to their liking—one that promotes their common interests and values alike—depends on their ability to agree on a set of common priorities and work together on their behalf. Transatlantic cooperation proved central to the successful outcome of the Cold War; continued partnership is likely to prove no less central to the course of 1999 and the years that follow. ■



Since Russia's financial meltdown last August, the West has all but given up helping that country reform its economy. "Tactical disengagement" is the new watchword. Exclusive responsibility for managing the West's economic relations with Russia has fallen to the International Monetary Fund. Predictably, matters have not risen above the level of bickering over details of the latest budget. Long-term, fundamental issues—changing the Russian economy, improving it, making it competitive—have given way to hoping that it can survive. The goal, if there is one, is to mark time.

Western policymakers appear not to recognize that the fate of Russia's economy is neither exclusively Russia's problem nor exclusively an economic problem. Although Russia, with its nearly \$200 billion of foreign debt, still has the ability to shake global financial markets—and likely will do so—the unquestionably bigger threat posed by its weak economy concerns national security. Russia's economic woes increase the nuclear threat to the United States.

BY BRUCE BLAIR AND
CLIFFORD GADDY

Russia's Aging War Machine

Economic Weakness and the Nuclear Threat

Russia's Small Economy

The Cold War military machine built up by Moscow proved economically unsustainable even for the USSR. But Russia, which inherited most of the Soviet military burden, has only half the population and perhaps 60 percent of the industrial base of the USSR. Moreover, Russia's economy, as measured by its GDP, has shrunk by roughly half since 1990. Still more important is the state of the public sector. For more than a decade, Russia's federal government has failed to maintain even the basic functions of ensuring national security, environmental safety, and public health. To a large extent, the state has become marginalized as a part of the Russian economy—the very reverse of the Soviet system.

The Soviet economy assigned first priority to building and maintaining state power, especially military might. The civilian economy, particularly the household sector, was the residual claimant of resources and wealth created; it had to make do with whatever was left over. Today, individuals and households can and do meet their own needs first, resisting in every way possible the claims of the state on them. The overwhelming majority of Russian farms produce nearly nothing beyond what their workers can consume. Many industrial enterprises do the same, producing barely enough output to sustain the existence of their own employees. Almost nothing is left that can be taxed to support the state apparatus. Moreover, the little that is available to the state is used in highly inefficient ways—primarily because so little state revenue is in the form of money.

Bruce Blair is a senior fellow and Clifford Gaddy a fellow in the Brookings Foreign Policy Studies program. Blair is the author of De-Alerting Nuclear Forces (Brookings, forthcoming); Gaddy, of Russia's Virtual Economy (Brookings, forthcoming).

The Nonmonetary Economy

Throughout the Russian economy, individuals, households, enterprises, and governments operate without cash. Very large enterprises are the extreme cases. Roughly three-quarters of their operations involve no money. But governments are close behind. Some city government budgets are no more than 5 percent money. The rest is in barter goods and debt swaps with providers of goods and services to the government. Even within the federal government, some agencies exist with almost no money at all. One such agency is the Ministry of Defense.

Russia's 1999 federal budget calls for defense spending of about 100 billion rubles. Using even the most generous estimate of the domestic purchasing power of the ruble, this is equivalent to no more than \$20 billion, or less than one-twelfth of the U.S. defense budget. But even this figure is misleading, for it implies that the Russian defense ministry has real money at its disposal. In fact, it has virtually none.

Over the past few years, Russia's defense ministry has built up debts to its suppliers that now total six to seven times the annual defense procurement order. The little "payment" that is made for goods delivered is not in money, but a credit for taxes owed to the federal and regional governments. Guided not by the needs of the armed forces, but by political expediency, the federal government bargains with powerful governors whose main concern is to protect jobs in their regions. The resulting practice of so-called offsets is typical of the highly inefficient use of even the minuscule nominal resources available to the Ministry of Defense. It is a seller's market. A ministry that should be making the wisest use possible of its limited procurement budget, concentrating on critical systems and upgrades, is forced to take whatever the factories have available—in most cases, not weapons at all, but rather

goods that can most readily be bartered for food and clothing.

Entire military units have become "self-financing." They barter the use of their trucks for food. They contract out their troops to farms in return for part of the harvest. For the military, as for the rest of Russian society today, barter allows people and institutions to survive. But the cost in terms of economic efficiency is huge.

The Cash Constraint

The ultimate constraint in this system is the minimal cash needed to pay wages, especially to officers whose families live off-base. Here, the situation is critical. The sharp increase in consumer prices after last August's financial collapse drove pay and allowances for Russian servicemen far below subsistence income levels. A pay hike scheduled for mid-1999 will at best compensate only for the inflationary loss, but will not be a real improvement over pay a year ago. And that was bad enough. In 1998 the defense ministry was able to cover only 50 percent of its planned budget for food and only 8 percent of the projected clothing budget. What little was available had to be used for conscripts being fed in mess halls. Officers' families typically had to rely on donations from relatives, friends, and neighbors.

As one officer's wife put it in a television interview in late March, "We have to hope our neighbors continue to support us and the two boys. So far, they have all pitched in. Even the pensioners in our apartment building bring food and beg us to take it, saying that they know that we are worse off than they are."

Economic weakness is strengthening the anti-Western, antidemocratic, and antimarket reform trends in Russia today. It is also steadily eroding the military's tradition of political neutrality. Although the military's aversion to Bonapartism appears to remain intact, rising nationalism draws additional strength from its growing politicization.

Effects on the Nuclear Forces

For Russia's conventional forces, the combination of lack of resources and the time and effort that must be diverted to sheer survival has been devastating to combat readiness. But nowhere does the weakness and inefficiency of Russia's state economy have more serious implications than

famous nuclear suitcases that accompany the president and other top authorities are falling into disrepair.

Prestigious institutes, such as the laboratories that design nuclear weapons, build the deep underground command posts, and engineer the communications links that would be used to send the "go code" to the strategic

weapons. But conditions that might drive individuals or groups to violate nuclear safety rules or threaten to fire weapons are ripening. At the least, worsening conditions of life and work in the nuclear forces decrease proficiency in managing weapons and sap motivation to adhere strictly to safety rules.

A meltdown of Russian nuclear control could be catastrophic for Americans. Securing Russia's nuclear weapons and materials and strengthening safety and control over operational deployments deserve top billing among the security priorities of the U.S. government.

in maintaining the sophisticated systems and men of the nuclear weapons complex.

The strategic weapons themselves are fast reaching the end of their shelf life, and Russia cannot afford replacements. Current aging forces have become more vulnerable. Surveillance satellites and radars are wearing out. Russia's early warning system is decaying as gaping holes develop and susceptibility to false alarms grows. Budget shortages, among other problems, prevent Russia from dispersing submarines and mobile land rockets into the sanctuaries of the oceans and forests. The Russian navy struggles to keep one or two ballistic missile submarines out of a fleet of twenty-six at sea, and at times cannot even do that. The Strategic Rocket Forces strain to disperse out of garrison into covert field locations a single regiment (nine missiles) of mobile rockets, out of a total mobile force of 350. Russian bomber pilots receive only about 20 hours of flight training a year, compared with 200 or more hours for their U.S. counterparts. Underground command posts are crumbling. Even the

rockets, are virtually bankrupt.

Like the conventional forces, Russia's nuclear units suffer from housing and food shortages, pay arrears, extended duty shifts owing to manpower shortages (massive draft evasion has depleted the enlisted ranks), and "moonlighting" to make ends meet. The competence and integrity of the generals who lead them have declined. They are demoralized and alienated from the state, which fails to support them, and the society, which no longer holds them in high esteem. They are themselves less impressive individuals owing to declining standards for admission to the higher military academies.

Hardship and disaffection at all ranks, enlisted and officer corps alike, have sharply increased the rate of suicides, crime, and political activity (the latter illegal for active military personnel). Remarkably, cases of disobedience and protest have so far been rare (though the wives of nuclear officers often stage demonstrations, sometimes interfering with operational activities). To our knowledge, no one has yet vented frustration by threatening to use, or trying to use or steal, nuclear

Greater Nuclear Reliance

Amidst all this decay, Russia strives to maintain the option to fire hundreds of missiles carrying thousands of warheads out of vulnerable silos on warning of an incoming missile strike. The crippled Russian missile force remains poised on hair-trigger alert, ready to fire at a moment's notice. This stance, inherently dangerous, is becoming more so as Russia's nuclear command and early warning system deteriorates.

By 1994 nuclear weapons had become the primary, and virtually the sole, pillar of Russian security. Recognizing its conventional military weakness along its entire border, the Russian government abandoned its longstanding commitment not to initiate the use of nuclear weapons in a conflict. Today Russia relies more than ever on using them first or launching them on warning of hostile missile attack. This growing reliance has not only lowered the nuclear threshold for intentional use but also increased the danger of mistaken or unauthorized use of nuclear weapons.

The Stakes for the United States

Should Americans and their government care about Russia's nuclear posture and its dissolution? The answer is an emphatic yes. American security is bound up in Russia's destiny, and our immediate security depends crucially on ironclad Russian control over its nuclear arsenal.

If we are very lucky, the Russian nuclear arsenal and control system will atrophy without incident, coming to a safe instead of deadly end. In such a happy scenario, this atrophy will also

encourage Russia to ratify the START II arms reduction treaty and negotiate even deeper bilateral reductions, lowering the ceiling on strategic deployments from 3,500 (START II) to 2,500 (START III) or fewer. Within a decade or so Russia's aging force could easily shrink to 500 or fewer, creating enormous latitude to negotiate vast reductions in deployments.

But this scenario is wishful thinking loaded with untenable assumptions. The START process has stalled and may not be revived any time soon, leaving in place increasingly decrepit and hazardous forces that Russia might not retire after all. The decay of the Russian arsenal is certain to run growing risks of proliferation and to erode safety along with basic offensive capability. For example, a degraded early warning network is less able to detect an actual attack—but also less able to screen out false indications of attack. Similarly, failure in the nuclear command link between the General Staff in Moscow and the launch crews in the field would disrupt not only the ability of the General Staff to quickly transmit the go code, but also the feedback loop from the missiles to the General Staff that detects and prevents an unauthorized launch attempt at any subordinate level of command. Finally, the departure of security guards from their posts at weapons depots to forage for food or escape inclement weather may not only impede the authorized dispersal of those weapons during a crisis but also increase the vulnerability of the weapons to theft. And the danger is not merely theoretical. A 1996 CIA report noted that broken locking devices on some Russian nuclear weapons had not been repaired for lack of spare parts. In short, progressive nuclear deterioration in Russia increases the risks of mistaken, illicit, or accidental launch, and the loss of strict central control over Russia's vast nuclear complex bodes ill for nonproliferation. If Russia's nuclear designers, producers, and custodians surrender to economic pressure, they could open the

floodgates to the illicit transfer of nuclear materials, weapons, and delivery technologies to America's adversaries.

A meltdown of Russian nuclear control could be catastrophic for Americans. Securing Russia's nuclear weapons and materials and strengthening safety and control over operational deployments deserve top billing among the security priorities of the U.S. government.

To alleviate the immediate danger, Russian and U.S. strategic missiles should be taken off hair-trigger alert so that none could be fired on a moment's notice. "De-alerting" our arsenals, ideally by detaching the warheads from missiles, would reduce their susceptibility to illicit or mistaken launch. Today it takes only minutes to prepare those forces for launch. Reducing the interval to days or longer would provide a far larger margin of safety against many scenarios, ranging from the temporary loss of legitimate civilian control over Russian weapons to false warning in Russia's early warning system—both more plausible dangers than a deliberate, cold-blooded attack by Russia or the United States against each other. The challenge of deterrence today pales beside the challenge of operational safety.

But even a comprehensive nuclear stand-down falls short over the long run. As long as Russia remains mired in economic, political, and military despair, the nuclear threat will continue. Russia will not be able to reduce its reliance on nuclear weapons until it can afford an adequate conventional military force. It will not be able to ensure control over its nuclear weapons and materials until it has a strong state, one based on a healthy economy and a civil society. The West's vital stakes in this process of nation-building have not diminished, despite all the failures and frustrations of the past decade. If anything, those stakes have grown—as have the cost and effort needed to stabilize and transform Russia.

While the prevailing political cli-

mate in the United States is to disengage from Russia, we believe that it is time to think big. Because of the stakes involved for our future, the nuclear issue is a place to begin. Our logic is that because a drastic reduction of Russia's nuclear arsenal is in our interest, we should be prepared to pay for it. In return for elimination of Russia's surplus nuclear weapons, Washington should compensate Moscow. As part of the deal, the United States would reduce its arsenal proportionately, and both nations' surplus weapons would be placed under international monitoring.

As an initial offer, we could think about transferring to Russia a sum equal to the historical U.S. cost per nuclear bomb—\$6 million—for each net unit reduction in the Russian arsenal. The saving that Washington would reap from the reduced burden of its own nuclear programs would be considerable, perhaps as much as \$300 billion over a 20-year period.

Russia will still need security assurances before it can reduce its reliance on its nuclear arsenal, and any grand bargain that promotes global nuclear safety as well as Russian economic revival would doubtless present a host of complications and obstacles, including the question of Russia's will to undergo economic reform or how best to reform. But neither of these key issues can be addressed without a vision big enough to offer the hope of success.

Since 1940, the United States has spent about \$400 billion on nuclear bombs and an additional \$5 trillion on delivery vehicles and the rest of its nuclear enterprise. Since the end of the Cold War, America's wealth, measured in the stock value of its companies listed on the U.S. stock exchanges, has grown by upwards of \$10 trillion. The United States and other prosperous nations can afford to consider a grander bargain with Russia than they have to date. Given the stakes and dangers, they cannot afford not to. ■

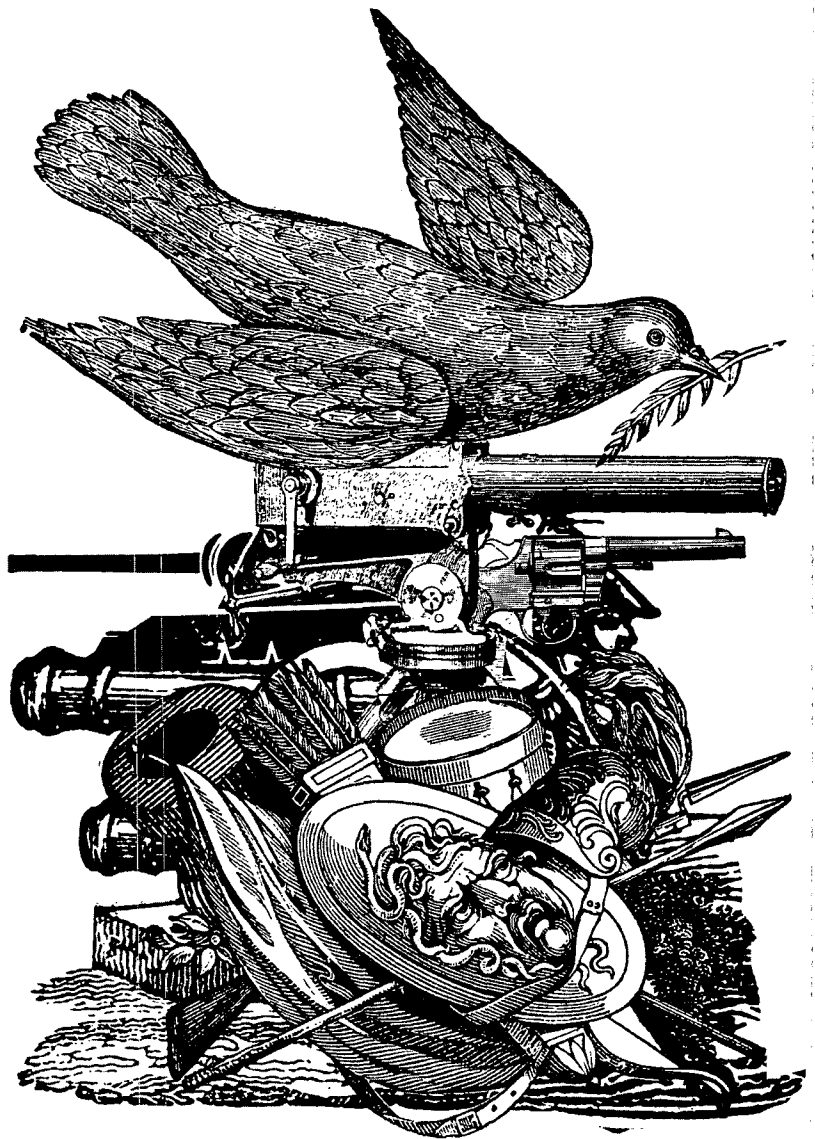
A Stable Peace in EUROPE

Can the Continent Put War Behind It?

BY JAMES E. GOODBY

The wars in the Balkans have made it starkly clear: nearly a decade after the end of the Cold War, Europe is only conditionally at peace; a deep chasm divides Russia and the West. The settlement in Yugoslavia will not alter this situation.

The United States and her NATO allies have decided in the case of Kosovo that internal ethnic conflicts may be defined as threats to international peace and security, justifying military intervention. This is a major innovation in European statecraft. The Helsinki Final Act of 1975 opened the door to sanctions against a state that denies human rights to its own citizens. The new precedent expands the scope of these sanctions dramatically. But it fits with a view in the West that wars between nation-states in Europe have become almost inconceivable, that intra-state conflicts are the principal threat. In a *New York Times* article on May 23, President Clinton argued that instability in the Balkans, fueled by a vicious campaign of ethnic cleansing, was the greatest remaining threat to a Europe that is peaceful, undivided, and free.



Fortunately, within some clusters of Western European nations peace has become stable, which means that war among them has become unthinkable. But the European system includes the Balkans and countries—Russia, the United States, and others—that are European because of powerful and inescapable reciprocal influences. Within this extended European family of nations, the possibility of wars between nation-states remains firmly imbedded today in the thinking and planning of all the major powers. One of the unintended consequences of the NATO-Yugoslav war has been to put this fact on public display.

NATO has added three new members for the stated purpose of expanding “the area in Europe in which wars simply do not happen.” The idea was to extend to the east the kind of stability that exists in Western Europe. President Clinton speaks now of doing for southeastern Europe what we did for Western Europe after World War II and of helping the nations of the region join NATO and the European Union. This raises the question of whether a serious goal of statecraft should be to achieve, ultimately, a stable peace throughout the European system of nations. Why stop with the Balkans? A Europe enjoying a stable peace can be counted among the low-probability events of the world at this time, but the unification of Germany also seemed to be a low-probability contingency until it happened. Russia’s uncertain prospects for achieving democracy and the deep divide between Russia and the West over the Balkans and other issues are at the heart of the matter. The future of the transatlantic relationship is also important and, in this context, is often overlooked. In the next few years, given conditions in

Russia, this relationship may bear the main burden of achieving a stable peace.

Peaceful, Undivided, and Democratic

Both post-Cold War U.S. presidents, George Bush and Bill Clinton, have held out the prospect of a Europe undivided by ideological claims. President Bush spoke of a “Europe whole and free.” President Clinton’s vision of a “peaceful, undivided, and democratic” European continent comes close to describing a community of nations where the threat or use of military force by one nation against other members of the community is not an option or even

close to it is a useful device for imagining what the continent should look like and for highlighting how varied are the forms it might assume. The exercise also will show that a stable peace is hardly the end of the story of international relations. The five models described below would look and act very differently from one another even though each assumes that all the major nations of the extended European system are democratic. For the sake of simplicity the models are constructed with the United States, Russia, and the European Union as the principal actors, but of course, every other potential member of

After centuries of war in Europe, historical experience does not encourage hopes for a stable peace, but enough has changed to make the idea worthy of serious consideration.

a consideration. Bush and Clinton seemed to be thinking not only of Western Europe, not just of geographic Europe, but of a larger system of nations, which they perceived as including the United States and, they hoped, eventually Russia. Neither president explained how this might happen or what the United States must do, if anything, to achieve this goal. After centuries of war in Europe, historical experience does not encourage hopes for a stable peace, but enough has changed to make the idea worthy of serious consideration.

Models of A Future Europe

In a speech in San Francisco in April, President Clinton remarked that “we must look beyond [the current conflict over Kosovo] to what...the whole continent of Europe should look like in 10 or 20 years.” Describing a Europe that had achieved a stable peace or come

this system will have some part in determining how it is constituted.

□ A system with three loci of power—the United States, the European Union, and Russia. The United States remains engaged in Europe; Russia is a solid democracy and functioning market economy; she takes an active and constructive interest in European matters; West European integration is successful, as is the enlargement to the east.

□ A system in which the United States is first among equals owing to greater cohesion and economic strength. The European Union is powerful economically but foreign policy is fragmented; Russia has established a solid democracy and a functioning market economy but is lagging behind the European Union and the United States economically.

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■ A system in which the European Union is dominant, while the United States and Russia are only loosely engaged with Europe. Russia is democratic but remains weak economically and politically, less focused on external affairs than on internal problems and issues involving her southern flank. The United States devotes increasing attention and resources to Asia; Europe takes the lead in managing European matters, demonstrating consensus and strong, unified leadership.

■ The West integrates while Russia becomes a peripheral player in European affairs. The United States and the European Union develop deeper trade relationships and closely coordinate their institutional arrangements; Russia is democratic in the electoral but not liberal sense, is experiencing internal difficulties, including inability of the central authorities to govern effectively throughout the Russian Federation. She is hostile toward the West.

■ The United States is dominant, but European coalitions, including Russia, are assembled to offset U.S. pressure. Europe is challenging U.S. policies on key foreign policy issues globally, and trade competition is fierce. Russia makes common cause with the European Union as necessary to resist U.S. political and economic pressures.

Assessing the Models

The term "Euroatlantic community" may be misleading since a clear differentiation among major power centers and groups of states within the system will exist even if a stable peace can be achieved. Fears of losing national identities in a featureless sea of Euroatlanticism are entirely misplaced. Differing sets of interests will generate different solutions to international problems and, hence, give rise to disputes. The only question is, how will they be settled?

A system based on North America, Russia, and the European Union that had achieved a stable peace is self-evidently preferable to the historical norm in which peace has been at best conditional, often precarious, and wars frequent. Some models of such a system might serve the interests of individual members better than other models, but if a stable peace, with all that implies, could be entrenched in Europe in the 21st century it would be a clear improvement over the experience of most preceding centuries.

This might not be the end of small wars, however, for even after a stable peace had been attained, pockets of authoritarianism might persist within the European system. Patches of ethnic or communal strife will be difficult to erase from the map, although the wars of the Yugoslav succession may be unique in their scale of violence. Small wars can destabilize relations among the major power centers, but they should not completely undermine a stable peace. The best insurance against that happening would be agreed policies and mechanisms designed to deal with ethnic or economic grievances—the preventive diplomacy of limited conflicts. The outcome of the Kosovo conflict may shed light on this. Multilateral security arrangements, like those now evolving among NATO, the European Union, and the Organization for Security and Cooperation in Europe, clearly will be needed even in a region enjoying a stable peace.

Reordering Foreign Policy Priorities

The idea of a stable peace in Europe still has not been cemented into the vital center of American foreign policy, either within the government or among the public. If a stable peace in Europe became a widely accepted strategic goal for the United States, like containment during the Cold War, effective transition strategies could be devised to help guide day-to-day decisions. This goal is more rhetoric than

reality at the moment. A reordering of American foreign policy priorities would be required if this and succeeding U.S. administrations took it seriously. The same is no doubt true for other nations, including Russia and members of the European Union.

The most obvious need for a course correction arises from the fact that U.S.-Russian relations have degenerated into bickering over Iran, Iraq, the Balkans, and nuclear nonproliferation policies to the point where the long-term strategic interests of the two countries are being defined by their differences rather than their common interests in a stable peace. Russian-American collaboration in finding a political settlement for Kosovo is a step in the right direction. A strategy aimed at making a stable peace in Europe, however, must be aimed at creating something akin to a security community, that is, a single security space throughout Europe, including Russia. Much can be achieved along these lines incrementally while internal conditions in Russia are being sorted out. Institutional linkages both with the center and with regions, joint peace operations as in the Balkans, and various forms of cooperative threat reduction can help.

When Russia develops the economic strength necessary to become a third center of power within an extended European system, Western policy should encourage that. During this transition, the minimum requirement for the West is constant support for democracy in Russia, including economic and other forms of help to underwrite what the Russians themselves are doing to strengthen the prospects for their democracy. In the West, greater accommodation to Russian views on the use of force, especially in Russia's neighborhood, and a sensitivity concerning the process of extending NATO's reach are needed and, in Moscow, more responsiveness to Western concerns about violations of democratic norms, regional instabili-

ties, and transnational security threats, such as terrorism and proliferation of weapons of mass destruction.

The transatlantic relationship is a more subtle issue. A Western commonwealth that accepts the differences in interests and outlook between Europe and North America will recognize a distinct center of power in Western and Central Europe—the European Union. A more balanced relationship between the United States and the European Union is what many Americans and Europeans have been urging for years, but inherent in the process is the inevitable diminishing of American influence over European policies, an unpleasant consequence for those Americans who consider that a benign hegemony is a more satisfactory policy.

American strategic interests outside the Western Hemisphere runs through Eurasia and that a stable peace is dependent on relations among the United States, the European Union, Russia, China, and Japan. Second, the exigencies of our age demand that the United States act before a clear and present danger emerges; this, in turn, requires a fixed and predictable place in the international power structure for the United States and a national strategy that Americans support and others understand. The choice for the United States is between some form of hegemony or striving to create equilibrium among these power centers. Hegemony would be impossible to achieve, the effort to achieve it waste-

making a stable peace in Europe requires judgments about how, when, and why to use military force. NATO already has become a hybrid defense system dealing with peacekeeping, as in Bosnia, as well as with collective defense. The air campaign against Yugoslavia fell in the latter category as a military operation. When peacekeeping or peacemaking is the objective, participation of units from countries other than the major military powers is preferable. If this cannot be arranged because of politics or because military efficacy rules it out, the involvement of all the relevant military powers is the next best solution. And if that is not feasible, the American profile in the operation should be kept to the lowest level compatible with effective operations.

There are political reasons for this set of rules. For example, NATO's role in making a stable peace could be undermined if misperceptions arose about American intentions in the Balkans. The most basic consideration is that the core function of U.S. military forces is to deter and, if necessary, to repulse armed state-on-state aggression in the Korean peninsula, in the Persian Gulf, and potentially at

A strategy aimed at making a stable peace in Europe must be aimed at creating something akin to a security community, that is, a single security space throughout Europe, including Russia.

The Task Undone

Hardly any government within the European system has outlined a vision of a future Europe so compelling as those of the last few American presidents, Reagan included. But if American presidents have meant to hold out the possibility of a Europe peaceful, undivided, and free as something more than a slogan, much remains to be done. Now, midway through 1999, it is time to reflect on how future U.S. administrations might pick up this task, considering both U.S. strategic interests and the use of U.S. military forces.

The effort must begin with the recognition that the main axis of

ful and damaging. Equilibrium, in the sense of limits on unilateralism and accommodation to the interests of other power centers, while difficult to manage, can engender cooperation including creating the conditions for dealing effectively with ethnic conflict elsewhere in Eurasia. Finally, in the 21st century, an American equilibrium strategy must deal with both ends of Eurasia simultaneously. Disconnected policies for Europe and for Asia—compartmentalization, in effect—is not compatible with globalization, which is here to stay, or with a coherent national strategy.

It is clear from our experiences in Yugoslavia from 1991 onward that

other points around Eurasia. In peacetime the presence of U.S. forces makes an essential contribution to stability and to cooperative relationships among the major military powers of Eurasia. U.S. defense operations and the defense budget should be oriented primarily toward that core function. The use of these forces in ways that would diminish their effectiveness in their core function should be minimized.

These prescriptions for policy run against the American grain in many respects, but they constitute a platform that will support a rational long-term U.S. engagement in international affairs. ■

THE U.S. DECISION TO ENLARGE

How, When, Why, and What Next?

On March 12 U.S. Secretary of State Madeleine Albright stood with the foreign ministers of Poland, Hungary, and the Czech Republic in the auditorium of the Truman presidential library in Independence, Missouri, and formally welcomed these three countries into the North Atlantic Treaty Organization. The Czech-born Albright, herself a refugee from the Europe of Adolf Hitler and Josef Stalin, said quite simply on this day: "Hallelujah."

Not everyone in the United States felt the same way. The dean of America's Russia experts, George F. Kennan, had called the expansion of NATO into Central Europe "the most fateful error of American policy in the entire post-Cold War era." Kennan, the architect of America's post-World War II strategy of containment of the Soviet Union, believed, as did most other Russia experts in the United States, that expanding NATO would damage beyond repair U.S. efforts to transform Russia from enemy to partner.

The controversy over NATO's enlargement sprang from contending visions of post-Cold War Europe. Some who favored enlargement, following in the footsteps of President Woodrow Wilson, believed that developing democracies and market economies in Central and Eastern Europe could create peace and prosperity there. They thought that the prospect of membership in the West's premier security institution would be a powerful incentive for continued reform. Other supporters focused more on the need for stability along Germany's eastern border, arguing that unrest there might lead Germany to believe that it had to undertake unilateral security efforts in Eastern Europe. Still other enlargement supporters, wary of the threat from Moscow, saw in the Cold War's end an opportunity to extend NATO's geostrategic reach in case Russia should ever again seek to dominate its European neighbors.

Passions ran just as strongly on the other side. Those who envisioned a chance to cooperate with Russia to reduce the dangers of nuclear war by dismantling and storing thousands of Russian

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NATO



nuclear warheads were appalled by NATO expansion; they believed that Moscow would regard NATO's inclusion of former Warsaw Pact nations as a direct affront and would drop its efforts to cooperate with the West. Still others, convinced that NATO had become the most effective military alliance in history, feared that adding new states in the east would impair its ability to address problems that might arise in Europe and elsewhere.

Given such controversy, enlargement of the Alliance was a highly uncertain prospect when the Clinton administration began discussing NATO's future in the summer of 1993. The new American president had won his election by focusing on the economy, not by promising to extend America's most solemn commitment to defend others. Inside the legislative and executive branches in the United States, there were few committed proponents of NATO enlargement. With the Cold War over and resources for foreign policy diminishing, only a handful of members of Congress showed any interest in NATO's future, and even fewer were thinking in terms of adding new members. Meanwhile, within the bureaucracy, officials who worked on NATO or Russian affairs were almost completely opposed to expansion, fearing its effect on the Alliance and on U.S.-Russian relations.

How did the handful of supporters of NATO enlargement within the Clinton administration prevail? Why did a Republican-controlled Senate give overwhelming support to a national security initiative put before it by a Democratic president? And what does round one of a process that NATO has promised will continue suggest for the future?

The Battles within the Clinton Administration

In October 1993, the Clinton administration and its NATO partners announced that they would unveil at the January 1994 NATO summit a new initiative to reach out to the east: the Partnership for Peace. The Partnership, a military cooperation program, was the product of bureaucratic battles over how NATO should respond to the Central Europeans' desire to join the Alliance. To the Pentagon, the Partnership was the perfect program—one that could build military relationships, involve all European countries, postpone the need to offer new security guarantees, and avoid confrontation with the Russians.

As 1994 unfolded, however, enlargement supplanted the Partnership for Peace as America's primary NATO policy. During a

GLENN PIERCE

visit to Prague in January, President Clinton stated flatly that “the question is no longer whether NATO will take on new members but when and how.” Six months later, in Warsaw, he added, “Now what we have to do is to get the NATO partners together and to discuss what the next steps should be.” In both capitals, urging the president to be clear about his intentions for NATO was National Security Adviser Anthony Lake, the most important of the early enlargement supporters. Clinton’s speeches in Prague and Warsaw gave NATO enlargement a big push forward—though, in the absence of any formal decision meeting, most of his bureaucracy did not notice.

Clinton’s interest in NATO enlargement had been sparked in April of 1993, when Czech President Vaclav Havel and Polish President Lech Walesa, two giants of Central Europe, had visited Washington and appealed to Clinton to erase the line drawn through Europe by Soviet dictator Josef Stalin. Shortly after their visit, Clinton and Lake articulated a vision of American foreign policy centered on the need to enlarge the community of market democracies. NATO, Lake suggested, could assist this effort in Central and Eastern Europe. Domestic political pressure from conservative Republicans and from the U.S. ethnic communities gave this broad strategic objective added resonance with a White House that always had an eye on the requirements for reelection.

Waving pages from the president’s Prague and Warsaw speeches in the air in late September of 1994, newly installed Assistant Secretary of State for European Affairs Richard Holbrooke told a stunned group from the Pentagon that the president had stated his support for enlargement and that it was up to them to act on it. Over the next three months, as skeptics inside the administration realized that the president, vice president, national security adviser, and secretary of state all supported NATO enlargement, the bureaucracy fell into line behind what emerged as a two-track policy to enlarge NATO while at the same time enhancing cooperation with Russia.

The Congressional Push

Meanwhile, on Capitol Hill, a handful of enlargement supporters had begun to prod the administration to move faster. Benjamin Gilman (R-NY) and Henry Hyde (R-IL) introduced legislation in the House of Representatives, followed by Paul Simon (D-IL) and Hank Brown (R-CO) in the Senate. Other vocal supporters included Republicans Richard Lugar (IN) and William Roth (DE). Their efforts culminated in the

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inclusion of NATO enlargement as part of the Republican Contract with America in September 1994 and, a month later, passage of the NATO Participation Act, giving the president authority to provide military aid to help the Czech Republic, Hungary, Poland, and Slovakia make the transition to NATO membership. For Republicans, the goal was largely to secure the victory of the Cold War by protecting new democracies from a future Russian threat.

Legislators in general tended to be indifferent to enlargement. Outside of a few vocal supporters, most were largely ignorant of European security issues. They may have felt generally positive about the Alliance’s role in the Cold War, but in the electoral environment of 1992–94, the vast

majority of congressmen and senators saw no reason to squander their time on an issue about which few constituents cared.

The Politics of Enlargement

The Clinton administration faced a variety of crosscutting political currents in the next phase of the enlargement process. Although the president had decided that NATO should expand at some point, he feared that moving too fast would jeopardize his single most important national security objective: assisting reform in Russia. While Boris Yeltsin’s seemingly precarious domestic position and Russian outbursts against enlargement pushed in one direction, Central Europeans and Republicans pushed in the other. The president could not be seen as holding Central Europe hostage to Moscow, but neither could he afford to undermine Yeltsin. Political logic dictated that Clinton could not be explicit about an enlargement timetable before the July 1996 Russian presidential election. But he had to say something concrete before his own reelection bid in November to reap the political benefits from his policy. Meanwhile, as long as the war in Bosnia raged, the United States could not hope to push the Alliance to enlarge.

By October 1996, conditions were ripe for an announcement. Yeltsin had been reelected. The 1995 Dayton accords had brought peace to Bosnia. Two weeks before the U.S. election, the president went to Detroit and, before a large audience of Americans of Central and Eastern European descent, proclaimed his support for new members to enter NATO in 1999.

Constitutionally, however, the process was just beginning. As the Clinton administration began seeking Senate advice and consent in 1997–98, some senators would want to be assured that Russia accepted this first wave; others would fear any arrangement that gave Russia too much influence. All

would want to believe that the costs of expansion would remain low.

The Senate Vote

In April of 1998 the Senate voted 80–19 in favor of admitting the Czech Republic, Hungary, and Poland to NATO. Several factors were crucial. First, with cost estimates low and Russia having been given a voice (but not a veto) in Alliance affairs through the 1997 NATO-Russia Founding Act, enlargement critics were mollified. Second, the administration's specially created NATO enlargement ratification office waged an effective national campaign, assisted by leading members of the Senate NATO Observer Group, by the Central Europeans and their ethnic supporters, and by Republican heavyweights in the U.S. Committee to Expand NATO. Endorsements poured in from business, labor, state and local governments, Jewish organizations, veterans, and leading former officials and retired military personnel. Columnists and academics who opposed enlargement on the op-ed pages and in leading journals had no comparable effort.

Finally, Senate Republicans believed that they—not Bill Clinton—had been the engine driving enlargement. Republicans had written enlargement into the Contract with America in 1994. They had driven the legislative process from 1994 to 1996. That Senate Republicans could claim this issue as their own made their consent far more likely than if the initiative had been seen as Democratic-inspired.

The Future of Enlargement

NATO's enlargement makes sense only if it delivers on the Clinton administration's open-door promise. Stopping after taking in three new countries merely redraws the line in Europe a bit further to the east, undermining Clinton's vision of NATO as the foundation of a unified, democratic, peaceful Europe. Political and economic reform in Central and Eastern Europe has proceeded largely because of the possibility of Western acceptance. Poland has developed civilian control over its military; Hungary has settled its border issues with Romania peacefully; the Czechs have carried out economic reform. Other aspirants, like Slovenia, Lithuania, and Bulgaria, have all adopted Western political and economic norms and institutions in a bid to become full members of the prosperous and peaceful Western order. Reform will be more likely to fail and instability to increase if NATO's first round of expansion is believed to be its last.

But while logic dictates that the process continue, future rounds will be more contentious. Three thorny issues that were finessed during the Senate debate of 1998 will have to be addressed as NATO looks beyond the first round. The first is Russia's reaction to enlargement. While some NATO aspirants, such as Slovenia and Romania, are not particularly threatening to Russia, any second round puts the Baltic issue to the fore. The Russians have repeatedly stated their visceral opposition to

including any former Soviet republic. If Lithuania were to meet Alliance membership criteria, it would be hard to explain why its claim should be less valid than the claims of others. Still, supporters of enlargement in round one who were able to set aside their misgivings about its effect on Russia would find it harder to vote yes in future rounds that raised a Baltic candidacy and thus led NATO onto the territory of the former Soviet Union.

The second issue, potential financial costs, must become more salient in a second and any subsequent rounds, because more members mean more costs, and the U.S. Senate made clear during its ratification debate that it did not want to spend significantly more on NATO. The final problem that will cause concern is potential dilution of the Alliance. Those who fear that enlargement means the end of NATO as a collective defense organization (and its transformation into a collective security pact) will want to see what effect the three new members have on the Alliance before expanding further. That, of course, would delay the second round.

The war in Kosovo has exacerbated all three concerns. Russia's reaction to NATO's attack on Yugoslavia has caused greater despair among those who already feared that expansion could lead to a new Cold War in Europe. Paying for the war will crowd out money for other purposes. And talk of the difficulties of warring by committee will heighten doubts that a larger alliance can function as an effective military machine.

In the first round of NATO enlargement, the United States demonstrated its leadership of the Alliance, and it reassured Germany that its eastern border would remain stable. NATO also granted Poland, Hungary, and the Czech Republic the security they have never known. And NATO demonstrated through enlargement (as it did by launching the war against Yugoslavia) that it is as much an institution of shared values as it is an alliance to defend shared interests.

Less clear is, first, what the future holds for the NATO-Russia relationship and, second, what will happen to the countries that still aspire to NATO membership. The answers to these two questions hold the key to a future Europe that is undivided, peaceful, and democratic. A truly cooperative relationship between a new NATO and a new Russia requires that NATO convince Russia that neither taking in new members nor adopting new missions is directed against it. It also requires that Russia convince NATO that it will stay on the right track politically and diplomatically.

As for those countries still aspiring to NATO membership, President Clinton and his NATO colleagues decided at NATO's 50th-anniversary summit in April that the Alliance would review the process no later than 2002, thereby postponing the issue of a second round for the next president of the United States. While it was Bill Clinton who argued that NATO could serve as the foundation for a unified, peaceful, and democratic Europe, it will be his successor who decides if NATO's future enlargement is not a question of whether, but of when and how. ■

EMERGING

BY IVO H. DAALDER

For much of its 50-year existence, the question of when and how the North Atlantic Treaty Organization could or would use force was never in dispute. As a military alliance formed to provide for the collective defense of its members, NATO sought to deter and, if necessary, defend against an attack by the Soviet Union and its Warsaw Pact allies on the territory of one or more of its members. Only in the 1990s did the question of when, where, and how to use force for purposes other than collective defense emerge. NATO's involvement in the Balkans—first in Bosnia, now in Kosovo—suggests that while the allies may remain divided in theory on issues relating to the use of force, they have in practice arrived at a consensus.



ANSWERS

NATO's Kosovo war provides answers to three questions that have stymied the allies during the 1990s. First, under what circumstances should NATO threaten or use force? Second,

although the threat of direct attack against Alliance territory as a whole has effectively disappeared, an attack against the territory of a single NATO nation is still quite possible. A country could launch ballistic missiles armed with conventional or more destructive weapons against a NATO capital or a military installation on allied territory. State or nonstate actors could unleash a terrorist attack. Or a more conventional attack could result either from deliberate action or, more likely, from the spillover of a regional conflict. In every case, NATO's Article 5 commitment to collective defense would come into play. Though the threats differ in nature from

Failure would have sealed NATO's future fate—ensuring not just that NATO would be much less likely to embark on Kosovo-type missions in the future, but also that the Alliance would have become increasingly marginal to the interests of its major members.

In considering whether to conduct non-Article 5 missions, NATO countries should generally act on the basis of a formal decision by the North Atlantic Council. Indeed, NATO's action in Kosovo dramatically demonstrated the importance of such unity of purpose. But the possibility for non-collective defense missions should not be conditioned on unanimous consent.

NATO'S KOSOVO WAR PROVIDES ANSWERS TO THREE QUESTIONS THAT HAVE STYMIED THE ALLIES DURING THE 1990S.

those of the Cold War, NATO's military response would be guided by the same collective defense principles.

A second type of challenge that may require a NATO military response involves crises or threats that do not directly affect allied territory, but that may have implications for important national or humanitarian interests. In both Bosnia and Kosovo, the Alliance has made such a determination, deciding to use military force even though the Article 5 collective defense commitment was not directly at stake. These non-Article 5 uses of force by the Alliance will increasingly define NATO's future purpose. The decision to threaten and launch an extensive bombing campaign against the former Yugoslavia in defense of Kosovar Albanians is a defining moment for the Alliance. Its success helps ensure NATO's place in the next century as the pre-eminent security organization for defending and extending security and stability within the Euro-Atlantic area.

Requiring a prolonged effort to build an Alliance-wide consensus for such action could result in unacceptable delay or even the failure to act, as happened in Kosovo in 1998. There the search for a NATO consensus delayed a military response past the point when it could have prevented the worst effects of the violent Serb crackdown in Kosovo and laid a foundation for a political resolution to the conflict that would not require a large international military presence to enforce it.

While always striving for consensus, the allies should agree that joint military action by a group of NATO allies may in certain circumstances be both possible and desirable even without a formal decision by the North Atlantic Council. Some very real concerns about such action must be weighed against the need for a flexible and adaptable instrument for joint military action at a time when allied interests vary more than ever. In the end, an Alliance that responds rapidly and effectively to crises in and outside

how far should NATO's writ extend geographically? Third, what is the legal basis for the threat or use of force by NATO in any of these situations?

When Should NATO Threaten or Use Force?

At least two types of challenges could require a NATO military response. First,

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allied territory, even if action is taken by a subset of allies, is preferable to one that conditions action on potentially unattainable unanimous support.

NATO's Geographic Reach

In principle, nothing in the Alliance treaty prevents NATO from taking military action wherever its members agree—in or out of Europe. In fact, the treaty encourages the allies to consult with one another and to coordinate their policies when and where possible.

In practice, however, no agreement exists on how far NATO's geographic reach extends. The United States, as a global power with global interests, argues that NATO should address threats to the common interests of its members, wherever the threats arise. From this perspective, NATO's fundamental purpose should shift, with the Cold War's end, from defending common territory to defending the common interests of Alliance members. At the same time, U.S. officials stress that such an alliance of collective interests would become not a "global NATO," but rather a NATO that is globally active.

But for most European allies—including even those, like Great Britain and France, whose interests extend well beyond Europe—the Atlantic Alliance remains a quintessential European security organization, whose fundamental purpose is to provide security in and for Europe. The debate among the European allies is not whether the Alliance should have a role beyond Europe, but rather how far beyond allied territory its role should extend. As the air campaign against Belgrade underscores, the allies have come to accept that NATO's role extends into the Balkans. At the same time, the difficul-

ties of the Kosovo operation confirm for many allies that this is about as far as NATO should go.

Many European allies are also quick to point out that their views of NATO's common interests, of the challenges and threats to those interests, and of the best way to respond to them often differ from those of the United States. These differences make it unlikely that they will agree to extend NATO's reach beyond Europe any time soon. For most allies, NATO is a regional organization

ing the use of force by NATO.

One perspective, strongly supported by France and, to a lesser extent, Germany, is that the use of force in international affairs, by a single state or group of states like NATO, is ultimately governed by the United Nations Charter. Under the Charter, NATO can resort to force in self-defense, either of a member state that is attacked or of a nonmember state whose government requests NATO's assistance. The former situation falls squarely within the collective defense commitment of the Washington Treaty; the latter, as Bosnia demonstrated, follows logically from the right of collective self-defense. At the same time, a narrow reading of the UN Charter suggests that NATO cannot use force against another UN member state without its government's consent unless the action is itself in defense



whose role is and will remain confined to the Euro-Atlantic region. Its members, however, may wish to act together outside of Europe on an ad hoc basis.

The Legal Basis of NATO's Threat or Use of Force

Of the many contentious issues relating to the threat and use of force by NATO, none has so divided the allies as the so-called mandate question—under what authority or on which legal basis can NATO threaten or use military force in other than a collective defense contingency. At the outset of this debate in the early 1990s, most allies (including Washington) believed that NATO should not act in this type of situation without an explicit mandate or authorization from the United Nations or the Organization for Security and Cooperation in Europe. Today Alliance views diverge sharply about the role and authority, if any, of the UN and other organizations in legitimizing or mandat-

of another UN member state or is specifically authorized by the UN Security Council. It follows from this reasoning that NATO can use force in non-Article 5 contingencies only if it is invited to do so by the state involved or if it is explicitly authorized by the UN Security Council.

This view is rejected most forcefully by the United States, which opposes holding NATO action hostage to the interests of non-NATO members like Russia and China. Moscow and Beijing want to avoid setting the precedent that NATO or any other group of states can intervene in the internal affairs of sovereign states. If such intervention were to be conditioned on UN approval, either or both of them would be bound to use a veto in the Security Council to prevent forceful NATO action. The insistence on a UN mandate thus implies that the brutality Europe has witnessed in the Balkans during the past decade, including the widespread abuse of

human rights and denial of fundamental freedoms, would go effectively unpunished or undeterred.

Not until the Kosovo crisis erupted in early 1998 were the NATO allies confronted with the practical implications of what had been up to that point a largely theoretical argument. By early fall, the Alliance was forced to consider whether to threaten significant air strikes against Serbia, a sovereign country in the middle of Europe engaged in indiscriminate violence against civilians in the province of Kosovo. Although the UN Security Council had unanimously voted in September 1998 to demand a halt to the attacks against civilians in Kosovo and the withdrawal of Serb security forces, a new resolution authorizing NATO to enforce compliance with these demands faced a near-certain Russian or Chinese veto. Nonetheless, the North Atlantic Council decided in October to activate NATO forces and authorize its supreme commander to commence air strikes—a threat that finally was carried out on March 24.

Faced, in the case of Kosovo, with the likelihood that the UN Security Council would veto NATO action in spite of a looming humanitarian catastrophe, NATO decided to act without explicit UN approval. But the larger issue remains unresolved. At the Alliance's Washington Summit in April, the allies acknowledged that the "UNSC has the primary responsibility for the maintenance of international peace and security," but they were silent on the question of who, if anyone, needs to authorize NATO's participation in non-Article 5 operations. And the NATO allies remain divided over whether Kosovo sets a precedent for the future. Whereas Washington argues that Kosovo demonstrates that NATO can act without an explicit UN Security Council mandate, other governments steadfastly maintain that the decision to launch airstrikes should not be seen as creating a right for NATO to arrogate a mandate.

Nevertheless, the Alliance seems to have struck a balance between principle and practice on the mandate question. While NATO should embark on non-Article 5 operations with the approval of the UN Security Council whenever possible, if its 19 members deem such action necessary then they should not be prevented from doing so by the likely veto of one of the Council's permanent members.

A Defining Test for NATO

The Atlantic Alliance is the premier security organization in Europe. In contrast to the European Union, the Organization for Security and Cooperation in Europe, and even the United Nations, NATO is today viewed by members and nonmembers alike as Europe's "go-to" organization. In Kosovo, the Alliance faces a defining test. Kosovo underscores that while NATO's core function must be to provide for the collective defense of its members, its central purpose in the new century must be to extend the security and stability its members have long enjoyed to other countries throughout the Euro-Atlantic area. The allies can achieve this purpose in part by continuing to hold the door of Alliance membership open to other European states. But they must also promote the values and interests that set Europe apart from other regions in the world—including support for democracy and the protection of human rights and fundamental freedoms. NATO brings to this task the unquestioned ability to deploy and use overwhelming military force. As Kosovo demonstrates, however, sometimes more than threats is required.

If NATO's central purpose becomes promoting security and stability throughout the Euro-Atlantic area, then it will be possible for the allies to agree when and how NATO should threaten or use force. Specifically, the allies need to see force not only as a credible deterrent and means of defending allied territory,

but also as a critical tool for helping to enforce the norms, values, and codes of conduct that govern behavior within and between states in the Euro-Atlantic region. That is what NATO has been doing in the Balkans during the past decade—including the use of force against tyrants terrorizing innocent civilian populations in Bosnia and Kosovo.

As for NATO's geographical reach, although the Alliance should provide a solid foundation for joint military action by allies when and wherever they deem it necessary, the focus should be on Europe rather than beyond. The Alliance is not today—or likely to become any time soon—an appropriate instrument for using force outside of Europe. Its planning horizon should therefore remain on Europe.

Finally, whenever possible, NATO should threaten or use force with the full backing of the international community, as expressed by the UN Security Council. It did so in Bosnia. The draft Rambouillet agreement for Kosovo stipulated that the UN be invited to endorse a NATO-led peace operation to support its implementation. But the Alliance cannot be held hostage to the dictates of non-NATO members. As an alliance of democratic states acting by consensus, NATO must preserve the possibility of acting without specific UN authorization. Even then, the allies should base their action on appropriate legal instruments, including the UN Charter and, for actions in Europe, the Helsinki Final Act and the Charter of Paris.

In sum, NATO enters the new century as the only major security organization capable of wielding significant military force in Europe. It should do so only in support of efforts to extend security and stability throughout the Euro-Atlantic region. And it can do so without recourse to non-European institutions so long as force is employed in support of sound purposes and principles to which all states in Europe subscribe. ■

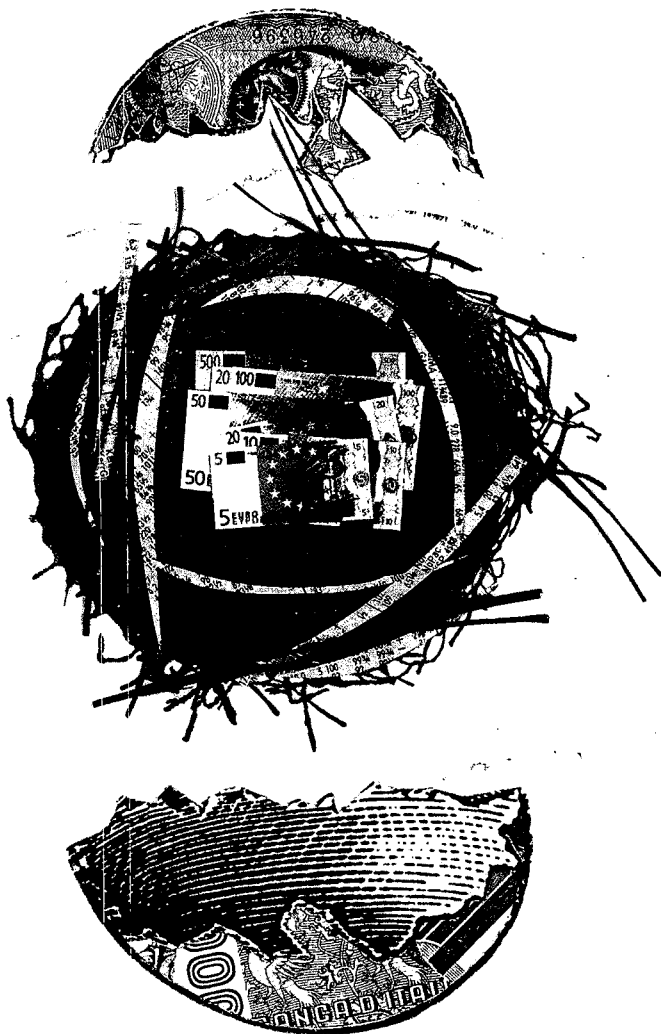
THE Birth OF THE Euro

BY ROBERT SOLOMON

FOR THE FIRST TIME since the fall of the Roman Empire, much of Western Europe now has a single currency. At the beginning of January the 11-nation European Monetary Union came into being and, with it, a new currency, the euro. Though Europe's familiar national banknotes will remain in circulation for three more years, the official currency of the EMU is the euro.

Monetary Union in Western Europe

Robert Solomon is a guest scholar in the Brookings Economic Studies program. For his more complete treatment of the international effects of the euro, see the Brookings Policy Brief no. 42, January 1999.



The European Monetary Union is the latest step in a decades-long movement toward integration in Western Europe. Soon after the end of World War II, French leaders Jean Monnet and Robert Schuman adopted European integration as the means to embrace Germany and keep it oriented to the West. German political leaders from Konrad Adenauer to Helmut Kohl and now Gerhard Schroeder have backed the policy, and France and Germany have consistently led the European integration movement. Ironically, though the motivation on both sides of the Rhine has been political, integration has been pursued almost entirely through economic and monetary means.

The Road to Monetary Union

The first step toward integration, in 1952, was the European Coal and Steel Community, a common market in coal, iron, and steel products joining Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, and the Netherlands. In 1957 the same six countries formed the European Economic Community, or Common Market, a customs union that grew to its current 15 members in what is now called the European Union.

In 1979 most members of the EU formed the European Monetary System—an effort to keep exchange rates stable in the EU. The new system narrowed differences in inflation and interest rates among most EU countries, and became, in effect, a deutsche mark zone. Exchange rates were kept stable by pegging to the German currency and following the lead of the Bundesbank in monetary policy. During the mid-1980s EU member states moved further toward integration by agreeing to try to eliminate restrictions on the movement of goods, services, capital, and people among themselves by 1992. Finally, in 1989, a committee consisting mainly of central bankers chaired by the president of the EU Commission, Jacques Delors, proposed a European Monetary Union. The proposal was adopted in the 1991 Treaty on European Union, often called the Maastricht Treaty—in effect the constitution of the EMU.

Under the terms of the treaty, countries wishing to join the EMU must meet certain “convergence criteria.” Efforts by EU governments to qualify for EMU membership led to further convergence of economic and monetary conditions in Western Europe. Consumer price inflation in Spain, for example, came down from 5.9 percent in 1991–92 to an annual rate of 1.4 percent in late 1998. Italy’s budget deficit fell from about 10 percent of GDP in 1991–92 to roughly 2.8 percent in 1998.

Only one EU country, Greece, failed to qualify for EMU membership on the basis of the convergence criteria. Three others—Denmark, Sweden, and the United Kingdom—chose not to join.

Features of the Euro Area

The 11 countries that make up the EMU have a population about 8 percent larger than that of the United States, but their

GDP is about 25 percent smaller. Individually, the economies of the EMU countries are quite “open”—in the sense that their external trade is a relatively large share of GDP—but because much of their trade is with each other, the euro area itself is a more “closed” economy. Excluding intra-EMU trade, exports plus imports amount to about 25 percent of GDP, compared with just under 20 percent for the United States (and 18 percent for Japan). The EMU has had a surplus in the current account of its balance of payments since 1993, while the United States has a large and growing external deficit.

Other differences set the EMU off from the United States. Euro area government expenditures and receipts are substantially higher, relative to the size of the economy. Unemployment is also higher (about 10.5 percent of the labor force, compared with just over 4 percent in the United States) and is believed to be largely structural—related to high labor costs, including various taxes and other charges on the employment of labor. Banking is much more important, relative to securities markets, in the euro area.

EMU central banking arrangements, known as the Eurosystem, bear some similarity to those in the United States (and also Germany). The European Central Bank (ECB) in Frankfurt, with its 6-member Executive Board, is comparable to the 7-member Federal Reserve Board in Washington. The 11 national central banks are analogous to the U.S. Federal Reserve Banks. Neither the ECB nor the Federal Reserve Board undertakes market transactions directly. Such transactions—discounting, open market operations, intervention in foreign exchange markets—are carried out by the national central banks in the EMU and the Federal Reserve Banks in the United States.

The main policymaking body of the Eurosystem is a Governing Council consisting of the Executive Board and the 11 national central bank presidents. It corresponds to the Federal Open Market Committee. The national central bank presidents constitute a majority of the Governing Council, while in the United States the seven members of the Federal Reserve Board have a voting majority.

The policy objectives of the Eurosystem, as set forth in the Maastricht Treaty, give primacy to price stability. But that objective being met, what is often ignored is that the treaty also calls on the new central bank to support the general policies of the European Union, including economic growth and employment.

The monetary policy of the Eurosystem remained unchanged from early January through early April. Its main interest rate, roughly comparable to the Federal funds rate in the United States, was maintained at 3 percent. A weakening of economic activity in the EMU in the fourth quarter of 1998—mainly reflecting a falloff in exports and gross investment—led the Governing Council to make its first change in monetary policy on April 8, when it lowered the basic interest rate to 2½ percent.

Initial Developments in the Euro Area

On January 4, the first working day of 1999, the exchange rates of the currencies of the 11 participating EMU countries were "irrevocably" linked to the euro and thus to each other. Banking and other financial assets, including government bonds, became denominated in euros. The euro began to be traded in foreign exchange markets (initially Sydney, Australia) on the evening of January 3, European time. Prices in many shops are being quoted in euros as well as national currencies, and credit card purchases may be made in euros.

The market value of the euro, \$1.186 on January 4, depreciated almost steadily in foreign exchange markets to just over \$1.03 in early June. The stronger performance of the U.S. economy provides part of the explanation, as does the fact that short-term interest rates, both nominal and real, are lower in the euro area than in the United States.

In any event, the weakening of the euro may have come as a surprise to those who had predicted an early rise of the euro against the dollar based on their expectation of a large worldwide shift of official and private assets from dollars to euros. So far, little evidence bears out that expectation.

Potential Problems

Although the EMU now has a single monetary policy and a single exchange rate, as does the United States, it nevertheless consists of 11 sovereign countries, each with its own budget. The 50 U.S. states also have their own budgets, but their ability to incur deficits is limited, both constitutionally and by the markets in which they sell their bonds. Washington faces no such limits.

Before EMU, central governments were regarded similarly. But now EMU member states are without their own central banks. That alone might limit their capacity to finance budget deficits. But there is another limit. A Stability and Growth Pact provides that member countries that fail to limit their budget deficits to 3 percent of GDP are subject to penalties unless GDP falls 2 percent or more in a year or special circumstances prevail.

It is clear that if the member countries could achieve near-balance in their budgets when their economies are operating at capacity, they would have latitude to incur cyclical deficits and to use discretionary fiscal policy when they move into recession. That latitude would become especially desirable if one or a few member countries were to suffer recession while the area as a whole continued to prosper. In such a case, the Eurosystem would not ease monetary policy by reducing interest rates, and the only policy tool available to the depressed countries would be fiscal policy—not only such automatic stabilizers as falling tax revenues and rising unemployment benefits, but also discretionary policy moves such as

tax cuts or increased government spending.

Another justification for flexibility of fiscal policy in the EMU countries is that labor mobility there is lower than it is in the United States. Partly because of Europe's language differences, when a European region suffers a rise in unemployment, its people are less inclined than Americans to go where the jobs are.

The Euro in the World Economy

How important the euro will become as a reserve currency held by central banks around the world and as a privately held asset is uncertain. Countries in Eastern Europe that aspire to join the EU will almost surely hold euros in their reserves and will probably peg their exchange rates to the euro. But central banks in general will not dump dollars on the market in large amounts to switch to euros, for that would simply lower the value of their remaining dollar holdings. To the extent that the euro becomes an important reserve currency, the process is likely to be gradual.

For the euro to become a growing part of countries' reserves requires a supply of euros as well as a demand. The United States, whose currency comprises almost 60 percent of world foreign exchange reserves, has demonstrated this principle only too vividly: it has for years regularly supplied dollars to the rest of the world by incurring deficits in its balance of payments. Even when its current account balance was in surplus, its capital outflows exceeded those surpluses, thereby providing a net supply of dollars to other countries.

If the euro is to become a major currency for private use internationally, the same principle applies. But European securities markets must also develop further to provide attractive vehicles for both investors and borrowers outside the EMU.

Yet another question is how the euro area will be represented in various international fora. It is clear who the central bank representative is: the president of the ECB, Wim Duisenberg. But who is the counterpart of national finance ministers and the U.S. secretary of the treasury? In fact, whose phone does the treasury secretary ring when a crisis arises?

Some observers have viewed the EMU as an anti-American move aimed at so-called American hegemony. Although the EMU will be a significant economic force in the world economy, it is far from politically unified and is unlikely to speak with one voice on international issues, economic or political. The EMU does not look like a serious threat to American interests. And the possible economic benefits to Europe in terms of growth will be welcomed by the United States and other countries. Washington has always encouraged moves toward economic integration in Europe, given their political motivation over the past half-century. Americans have good reasons, both political and economic, to continue this tradition. ■



BY ELIZABETH POND

A New Financial SUPERPOWER?



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THOUGH EUROPE CLOSELY RESEMBLES THE UNITED STATES in many ways, it is by no means its equal in the management of financial instruments. U.S. stock, bond, and derivative markets are by far the biggest, most liquid, most flexible, and most complex in the world. European bourses, by contrast—with the partial exception of Britain—have been small, segmented, and illiquid. Even taken together, they are only two-thirds the size of the U.S. stock market. Current German stock market capitalization is only 38 percent of GDP, by contrast to 138 percent in the United States and 163 percent in Britain. While half of British private-sector financial assets were in equities in 1996, only 20 percent of private funds were similarly placed in more conservative Germany, France, and Italy.

Elizabeth Pond is the author of The Rebirth of Europe (Brookings, 1999), from which this article is excerpted.

Effects of Economic Union in Europe

As European Monetary Union introduces a continent-wide financial market in Europe, along with a corresponding altered investment mentality, all that will soon change. EMU, as the final step in establishing Europe's single market, is already acting as a catalyst in Europe's boardrooms and chancelleries. Within a decade—barring some euro catastrophe—Europe should become the second financial superpower, in accord with its wealth. Europe's 30-plus segmented stock exchanges are beginning to merge and expand their scope. Even before British accession to EMU, the large London and small Frankfurt exchanges have begun an "alliance" that will allow shares to be traded at both locales, and the French, Italian, and Spanish bourses are waiting to join in.

Toward a New Equity Culture

Europeans are also rapidly developing an American-style equity culture. They are heeding the constant cry of their own liberal reformers that they must emulate American entrepreneurs. The characteristic continental capitalist model of in-house bank financing of corporations is giving way to less cozy (and cheaper) equity and loan flotations on the British and American model. Remaining regulatory barriers are slowly being pulled down; German banks are being permitted a wider range of investment activity; obsolescent German and French requirements that borrowers originate deutsche mark- or franc-denominated issues in their domestic market are falling by the wayside. Italian mutual funds have begun to attract big money. Germany's long-delayed tax reform is inching forward toward lowering corporate rates and dropping the bias that has previously rewarded investment in real estate over productive investment.

So far Europe lacks the independently managed pension funds that are a mainstay of U.S. stock investment; pensions have been largely state-run, pay-as-you-go schemes, with legal restrictions more or less confining them to safe, low-yield domestic bond issues.

This branch, too, should now develop rapidly as retirement pay adjusts to the demographic realities of aging populations and tight government budgets.

Europewide Competition

These changes, and others, all follow from EMU's unification of European capital markets and forcing down of costs as the new transparency translates old lira and franc and peseta prices into the same easily compared euro prices, compelling companies to match the lowest price or else lose sales. Anticipating these shifts, industrial stalwarts like Hoechst, Veba, and BASF have already carried out aggressive cost-cutting and moved substantial manufacturing to cheaper Central European, Asian, and Latin American factory sites. A wave of mergers and acquisitions paralleling the American trend has begun. Firms like the Swedish-Swiss ABB engineering conglomerate, which have thought globally for more than a decade, are seen as models. The old priority on national champions is becoming increasingly passé; transnational mergers are producing corporations in various sectors that will be able to hold their own on the world market.

Volkswagen—despite threatening to pull out of its new plant in eastern Germany if the European Commission enforced its ruling against excessive subsidies from the state government of Saxony—not only outbid BMW to purchase the venerable Rolls-Royce, but went on to buy the equally renowned Lamborghini, and this after having earlier bought the Czech Skoda and Spanish Seat. Airbus, with French, German, British, and Spanish participation, is turning into a major rival of Boeing. Even defense industries are uniting across state borders—though more slowly, with frequent setbacks, and against French resistance. The new Eurofighter is a German-British-Italian-Spanish collaboration; Germany and Spain will shortly be producing joint tanks, Germany and Sweden joint missiles; the Nordics are buying helicopters

together; and the threat that British Aerospace and Daimler-Benz Aerospace might merge without them has goaded the French to privatize Aerospatiale in order to join in.

The shakeout has not yet overturned small and medium-sized firms, the inner core of Germany's economic engine and the sector that must provide the jobs for redundant workers from the slimmed-down giants. But even here change is beginning—and will presumably be carried forward by the sons and daughters who are now inheriting post-World War II family businesses from their founding fathers and, less frequently, mothers. Venture capital is appearing even in risk-averse Germany, as the success of the country's thriving Neuer Markt, the exchange for innovative start-ups, attests. Germany's profusion of little banks is on the verge of consolidation to fewer, more efficient banks, with more solid capitalization.

Across Europe and Beyond

Indeed, the economic ferment in the EMU extends across Europe. A new openness to experiment prevails as central European countries privatize telecommunications, energy, and other natural monopolies on their tabula rasa, or skip the pay-as-you-go stage of pensions in favor of full funding—then export these ideas back to Western Europe. There is unprecedented curiosity about how Ireland shifted from a classic land of emigration to one of immigration, or how Poles, with a standard of living less than a third that of France, are financing those pension funds, or how Dutch employers and employees worked together to generate part-time jobs that please everyone.

And although the ongoing merger fever has to some extent pitted the United States and Europe against each other, to American businessmen, the striking thing about the new Europe is the opportunity it presents for American investors, especially given the current soaring dollar and slumping euro. Unlike Japan, Europe holds its economy

Europe will be following the path the United States took in the late 1980s and early 1990s in streamlining, restructuring, and regaining the competitiveness it had lost to Asia.



open to outsiders, and some German officials argue that agile U.S. firms have profited even more from the developing European single market than have less supple European companies. Citibank, for one, has gained a leading position in Germany by pioneering functions that domestic banks have been slow to offer. U.S.-based international accounting and management and even law firms are moving into, or expanding in, Europe.

The current burst of restructuring and realignments already includes major transatlantic investment and mergers. Daimler-Benz was the first German company to be listed on the New York Stock Exchange—and to obtain the listing it was willing to adopt U.S. accounting standards and greater financial disclosure than the secretive German corporate world practices. It is producing automobiles in Alabama—and its rival BMW has assembly lines in South Carolina. DaimlerChrysler will soon be a household brand in America. Bertelsmann, the world's third-largest

media conglomerate, recently bought out Random House and now represents many of the top authors on best-seller lists in the United States. The Star transatlantic (and transpacific) airline alliance is now competing with the "oneworld" transatlantic (and transpacific) alliance. The first transatlantic law firm merger brought Salans Hertzfeld Heilbronn Christy & Viener into being in 1999, with offices in Paris, London, New York, Warsaw, Moscow, and Almaty.

As European businessmen become more American—and as EMU's transparency, reduced transaction costs, and economies of scale take hold—European firms will also become more competitive with American firms. In theory, this is all to the good. Europe will be following the path the United States took in the late 1980s and early 1990s in streamlining, restructuring, and regaining the competitiveness it had lost to Asia. Europe's competitiveness will in turn drive the next round of innovation

in the United States, and American and European consumers and investors alike will benefit from such benign rivalry.

In practice, of course, the European rejuvenation is sure to distress North Carolina textile spinners, Indiana steel workers—and House Minority Leader Richard Gephardt. The advantages of open world trade will not be as obvious to many Americans as they are to Germans who buy summer houses in Tuscany or Greeks who run pizza parlors in Sweden. Once the U.S. economy ends its phenomenal present roll, resentment could lead to a protectionist backlash; aggrieved Americans could easily view themselves less as advantaged consumers buying bargain imports than as workers who have lost their jobs to "unfair" foreign competition. The precise political outcome may depend on just how many Tuscaloosa automobile assemblers train in Germany and come back with the sense that what is good for Europe is also good for America. ■

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In Search of National Consensus and a New Political Center

BY HEINZ KRAMER

Last October 29, the Republic of Turkey celebrated its 75th anniversary with an impressive show of republican sentiment and national pride. In streets and public places hung with hundreds of thousands of Turkish national colors and adorned with pictures of Kemal Atatürk, the “father of modern Turkey,” flag-waving crowds in Turkey’s large cities celebrated by chanting Kemalist slogans. The clear impression was of a united and stable country that has successfully negotiated a comprehensive social and political modernization.

Political developments of the past decade in and around Turkey, however, reveal a different picture. At home, the political center has weakened in the face of political movements, especially political Islam and the Kurdish question, that challenge the Kemalist model of a secular republic and the unitary nation and state. As the erosion of the traditional Western-oriented political center has accelerated, more extreme views have been established on the political scene. In Turkey’s parliamentary elections of April 18, parties such as the ultra-nationalist Nationalist Action Party, the Islamist Virtue Party, and the pro-Kurdish People’s Democracy Party gathered a combined vote of almost 40 percent. The moderate parties of the center-right and center-left that once won about 75 percent of the electorate took only about 57 percent of the national vote. The continuous growth of the Islamist forces and Kurdish insurgency has made the military increasingly influential in Turkish politics: national stability now comes at some significant cost to Turkish democracy.

Externally, the international sea change following the end of the Cold War also vastly

changed the country’s foreign and security policy environment, weakening Ankara’s bonds with its Western allies and stimulating Turkish assertiveness in relations with neighboring countries. As a result, Turkey’s foreign policy is undergoing tentative change on two fronts. First, Turkey is seeking a new balance between cooperative engagements in multinational frameworks and the more or less single-handed pursuit of national interests on the basis of a greatly enhanced, and still growing, military capability. Second, Turkey’s political establishment is increasingly on the lookout for new foreign policy horizons beyond the country’s traditional exclusive orientation toward the West and its European institutions. Turkey is not severing but redefining its relations with its Western allies, while reaching out for a broader Eurasian role as well.

Turkey’s foreign policy orientation is of considerable importance for its American and European partners. Turkey plays a significant part in developing the energy resources of the Caspian Sea region. Turkey’s contribution to containing Saddam Hussein’s regime in Iraq,

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as well as its strategic cooperation with Israel, are important for the future of the Middle East. Ankara is promoting cooperation in the Black Sea area and is supporting the Newly Independent States of Central Asia in their drive for national consolidation and independence. Peace and stability in the eastern Mediterranean depend on Turkey's readiness to solve its longstanding disputes with Greece and to help solve the Cyprus problem. Turkey's developing relations with various Balkan states are key to establishing cooperative structures in that region. Finally, the construction of a new European security architecture depends on Turkey's support for NATO's enlargement and restructuring. All these issues are of great strategic importance to the core countries of the Atlantic Alliance, and Turkey's development cannot be ignored or neglected by its Western partners.

Erosion of the Political Center

Because of the weakening of Turkey's political center and the growth of extreme factions, no party has gained a political majority since 1991. Governments have had to be based on generally short-lived, weak coalitions—often between ideologically opposed parties because the bitter personal rivalry between ideologically related leaders makes coupling parties from the same “family” almost impossible. Domestic politics has thus degenerated into a mere power struggle dominated by short-term tactical considerations. Political corruption has increased, as have ties between leading politicians and organized crime.

Meanwhile, pressing problems resulting from rapid economic and social change over the past 15 years have festered. Uncontrolled urbanization, growing income disparities between different population groups and between different regions of the country, the bankruptcy of the national systems of social security and health care, the steady decline of the educational system—all have gone almost unchecked. Persistent high inflation—at least 60 percent annually during the 1990s, with temporary peaks above 100 percent—has gnawed away large portions of the personal wealth of Turkey's masses. Not surprisingly, growing portions of the population have lost confidence in the established political elites and parties.

The Revival of Political Islam

Amidst the social disarray, radical political forces, both nationalist and Islamist, have gained prominence. Political Islam, represented by the Welfare Party of Necmettin Erbakan, made deep inroads among the impoverished urban masses in the squatter town areas of western Turkey's urban agglomerations. The party offered its services based on a political conception more in line with the traditional Turkish world view than the official Kemalist ideology as represented by the political parties of the center. At the same time, a new type of Islamists, exemplified by the former mayor of Greater Istanbul, Recep Tayyip Erdogan—urban, well-educated, modern—enhanced the party's attractiveness among the urban middle classes and the younger generation.

The rise of political Islam posed a severe challenge to the established Kemalist state elite, especially the military leadership and the upper echelons of the state bureaucracy and the judiciary. In June 1997, military-instigated political pressure ousted Erbakan from the prime ministry he had gained in a coalition government forged with Tansu Çiller's True Path Party. In February 1998, the Welfare Party was closed down by the Constitutional Court, and Erbakan was banned from politics for five years. The Virtue Party, successor to the Welfare Party, is also facing a politically-inspired closure procedure in the Constitutional Court, and at the same time its leading representatives have been charged with various crimes.

Nevertheless, as the April elections show, the Islamists remain a political force in Turkey, albeit on a somewhat reduced level. They are still strong at the local level and cannot be eradicated by legal and administrative means. Even if the Virtue Party is shut down, Islamists will continue to attract a considerable part of Turkey's population. Until the so-called secular political forces of the center regroup and regain their lost credibility with the masses, the military is fighting an uphill struggle against political Islam.

The Perennial Kurdish Question

A second serious challenge to the established Kemalist state tradition, the Kurdish quest for recognition as a distinct ethnic group with special rights, has also increased involvement of the military in Turkish politics during the past decade. The armed struggle—“separatist terrorism,” as it is known in official Turkish language—of the Kurdistan Workers Party, the PKK, against the Turkish state is but another round, albeit the longest and most violent so far, in the decades-old Kurdish effort to gain acceptance of their distinct ethno-national identity by the Turkish state.

The past 15 years of fighting have cost the lives of some 30,000 people, about two-thirds of them PKK fighters, but also 4,200 Turkish soldiers and 5,300 civilians, Turks and Kurds. An especially dark side of this picture is the so-called extra-legal executions and other murders of mostly PKK sympathizers and other representatives of Kurdish interests such as lawyers, journalists, and politicians. According to a January 1998 report of a parliamentary commission, some 3,200 villages and hamlets in the Kurdish provinces have been destroyed either by state authorities or by PKK guerrillas. About 380,000 inhabitants were forced to migrate to regional centers like Diyarbakir, and many more people left the area because their livelihoods had been destroyed. It is estimated that up to 3 million people migrated from the Kurdish region to the urban centers in western and southern Anatolia to escape the devastation.

As with the Islamists, however, the state did not eliminate the Kurdish security problem. To the contrary, the militarization of public life in the southeast and the heavy repression of all forms of explicit Kurdishness furthered the growth of national consciousness among Turkey's Kurdish population. Today far more Turkish citizens of Kurdish ori-

gin support some form of cultural and political autonomy for the Kurds than in 1984, when the PKK started its activities. The pro-Kurdish People's Democracy Party won the April elections with a convincing plurality of votes in 11 central Kurdish provinces although it was unable to gain any seats in parliament because it failed the nationwide 10 percent electoral threshold. The capture of PKK leader Abdullah Öcalan last February and his likely sentencing to death will not end the Kurdish question. Nor, probably, would a total victory of the Turkish army over the PKK finish Kurdish aspirations for recognition. The only answer is for the Turkish state to switch to a nonmilitary, nonrepressive approach to the issue and to work for a democratic solution of the Kurdish question.

Curtailing Turkish Democracy

A democratic solution to these problems, however, may be too much to expect of Turkish democracy today. The military-led defense of the Kemalist system against its Islamist and Kurdish challengers has severely curtailed the democratic freedoms and civil rights of all Turkish people, as annual U.S. State Department reports on human rights in Turkey make clear. Even nonviolent expressions of opinions that deviate from the official state ideology of the unitary, secular Kemalist republic and its indivisible nation run the risk of prosecution by state authorities—as witnessed by the recurrent closing down of Islamist and Kurdish political parties and the widespread persecution and jailing of journalists, intellectuals, and even politicians for crimes of conviction. The consequent silencing of all moderate spokesmen for Islamist and Kurdish interests may well radicalize dissenting groups, making a democratic political solution of the issues even more difficult in the future.

Over the past 10 years, Turkey's military leadership has consolidated its role as guardian of the established Kemalist system and has become a political actor in its own right—though, in sharp distinction to all other NATO member states, a political actor that evades effective democratic parliamentary control. The defense of the Kemalist system, besides its ideological aspect, is also a struggle for power between the established state elites and rival elite groups with a different political and social background—political Islam and Kurdish nationalism. Widening the legitimate political spectrum of Turkish democracy to include nonradical Islamist and nonviolent Kurdish groups would therefore imply the sharing of power and its benefits among a larger number of potential contenders—a development especially hard to accept for a military leadership that has gotten accustomed to its privileged position.

Public criticism of the deficiencies of Turkish democracy is growing, but slowly. The tremendous economic, social, and political development in Turkey since the foundation of the republic has nurtured civil society, as well as public awareness of the undemocratic features of Turkey's political system. But proponents of more liberal democracy—representatives of Turkey's big business, some of the country's leading journalists, the vocal human rights organizations—have as yet had only a limited impact on political

developments, as most political parties seem reluctant to adopt suggestions from civil society groups, and the military leadership is immune to such outside influences.

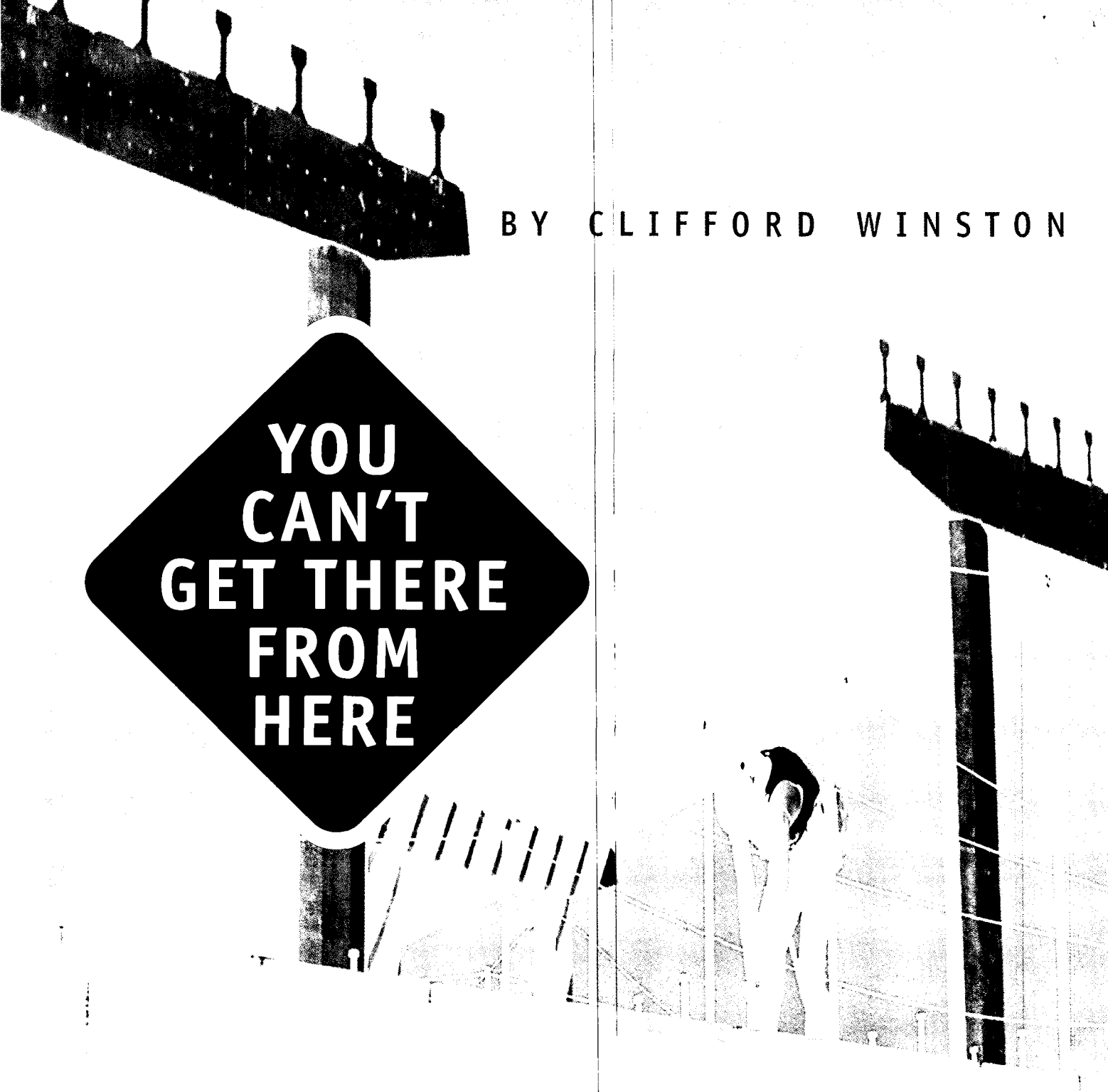
Challenges to Western Policy

In shaping relations with Ankara, Turkey's Western allies and partners must take into account the country's fragile domestic situation, its unsettled societal and political cleavages. Turkey clearly has a potentially critical role in shaping the future of a region of critical international importance. But to play that role most constructively, Turkey must first address its domestic political problems. Turkey's increasing opening up to the outside world since the mid-1980s must be complemented by a more open and democratic pluralist society at home. One promising strategy would be to forge a "reform alliance" between the severely diminished political center and the most prominent groups of civil society. Such a strategy, however, would require Turkey's social democrats and the parties of the center-right to remember their progressive political roots and reshape their parties—and their leaders—accordingly.

Turkey's Western allies can do little to directly support such a development from the outside. They should, however, make unmistakably clear that they want Turkey to remain firmly inside the Euro-Atlantic political fold, and they should openly support those forces in Turkey who share this view. European and American partners should also continue to stress the values that characterize the Euro-Atlantic system as they have again been confirmed by the NATO summit in Washington and remind Turkish leaders that their country still has some way to go to meet these requirements in full. European and American political leaders should engage in a confidential dialogue to develop a common policy for anchoring Turkey more firmly in the Euro-Atlantic system.

Turkey's European partners should also more openly and seriously take into account Ankara's sensitivities with regard to developing a new European security architecture. Discussions about a more prominent European role in security and defense should explicitly assign Turkey a place in such schemes even if the country will not become a member of the European Union in the foreseeable future. What is needed is a "European strategy" for Turkey that goes beyond the narrow frame of EU-Turkey relations and includes economic, political, and security aspects of Turkey's role in and for Europe.

The United States, too, should develop a more comprehensive and consistent policy toward Turkey. Close cooperation with Ankara about the future of the Kurdish question in Turkey and in the region as a whole would help diminish the widespread feeling among Turkish leaders that Washington regards Turkey primarily as an instrument for realizing crucial American strategic interests in the region. A permanent high-level American-Turkish political dialogue on developments in the "greater Middle East" would also help ease much of Turkey's feeling of not always being consulted properly with respect to American policy that also affects crucial Turkish national interests. ■



BY CLIFFORD WINSTON

**YOU
CAN'T
GET THERE
FROM
HERE**

Government Failure in U.S. Transportation

Getting goods and people to their destinations accounts for an enormous share of U.S. economic activity. In 1996, Americans spent roughly \$600 billion commuting to work, traveling for pleasure, and buying and operating vehicles. Firms spent more than \$500 billion shipping products to distribution centers and retail outlets, sending their employees to meet with customers and suppliers, and buying and operating vehicles. Local, state, and federal government spending on transportation infrastructure and services upped the total to \$1.3 trillion or roughly 17 percent of GDP.

Transportation also absorbed users' time—a valuable commodity excluded from GDP. In 1996, travelers spent roughly 120 billion hours in transit, and surface and air freight absorbed 3.4 billion hours. If travelers value time at half their hourly wage—a common assumption among economists for urban commuters—and if shippers attach a cost of, say, 7 percent of their shipments' value for each additional day spent in transit, then transportation accounts for another \$1.2 trillion in economic activity.

Transportation is also an important means for government to exert its influence on the economy. Washington, in cooperation with foreign governments, effectively regulates international air and ocean transport. State and local governments regulate taxis in most U.S. cities. Local governments, with state and federal financial support, are quasi-monopoly providers of urban bus and rail transit. A federal government corporation (Amtrak) is a monopoly provider of intercity passenger rail transport. Most U.S. roads, bridges, airports, and ports are owned and operated by federal, state, or local governments. All modes of transportation are subject to governmental safety, pollution, and noise regulations. Research and development of new transportation and infrastructure technologies is largely supported by the

government. Virtually the only exception to this rule of government involvement is intercity rail freight, truck, and air transport, large parts of which were deregulated by Washington in the late 1970s and early 1980s. And even there, Congress and the Department of Transportation sometimes cannot seem to leave well enough alone.

Policymakers who view the huge transportation market as subject to a variety of serious market failures—economies of scale, negative spillovers such as congestion and pollution, and imperfect information—believe such extensive government intervention is necessary to correct those failures. But others, myself included, believe the potential market failures are exaggerated and that the government has done more harm than good.

In my view, the preponderance of scholarly evidence developed in transportation economics over the past several decades leaves no question that the government should greatly reduce its role in all aspects of transportation. By repeatedly failing to enact efficient policies to correct market failures and by rigidly pursuing policies that have undermined the efficiency of every transportation mode and the welfare of most users—especially those with the lowest incomes—policymakers have

assured that pervasive government failures are compromising the performance of the U.S. transportation sector far more than market failures.

This is not to say that getting the government out of transportation will be easy and that the private sector will perform flawlessly in the transportation market once government involvement is curtailed. But by ridding the transportation sector of most observable government failures and by allowing innovation and state-of-the-art technology to flourish free of government interference, the private sector can vastly improve transportation and thereby advance our standard of living. The only real uncertainty is how long policymakers will resist change.

EVIDENCE OF GOVERNMENT FAILURE: THE DEREGULATION EXPERIMENT

Scholarly journals, as well as newspapers and magazines, are replete with assessments of and opinions about the effect of government policy on transportation. The popular media often report sharp disagreements—disagreements that turn out largely to reflect the views of interest groups and ideologues. The scholarly assessments, by contrast, have reached a consensus. Without pretending to be exhaustive, I

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will distill the scholarly evidence in what follows. Readers wishing a more comprehensive discussion are encouraged to consult the research cited.

Perhaps the earliest empirical evidence of government failure came in scholarly analysis of the economic effects of government regulation of rail freight, trucking, and airlines. This evidence was crystallized by assessments of rail freight, truck, and air deregulation that showed significant improvement in transportation efficiency when tasks once performed by the government were handed over to the market.

Regulatory Policy toward Intercity Carriers

According to the conventional argument that has prevailed for much of this century, economic regulation of railroads and airlines was supposed to benefit society because both modes were alleged to be natural monopolies (an unusual situation in which social costs are minimized when one carrier

FOR THE MOST PART, DEREGULATION HAS WORKED THE SAME WAY IN EACH INDUSTRY—AND EVEN BETTER THAN EXPECTED.

serves the market). Price regulation would protect consumers from monopoly abuses, and entry and exit regulation—rules governing when a carrier could serve or leave a market—would assure efficient and dependable service. Trucks were never considered natural monopolies, but at the railroads' insistence their operations were brought under the regulatory umbrella.

Although the Interstate Commerce Commission began regulating railroads in 1887 and trucks in 1935 and the Civil Aeronautics Board began regulating airlines in 1938, it was not until the late 1950s and 1960s that scholarly studies began to reveal that regulation was harming consumers. For example, in a

1965 *Yale Law Journal* article, Michael Levine found that flights from Boston to Washington cost considerably more than flights—of roughly the same distance—from San Francisco to Los Angeles. The explanation was that fares on the interstate Boston to Washington route were regulated by the CAB while fares on the intrastate San Francisco to Los Angeles route, overseen by the California Public Utilities Commission, were determined primarily by market forces. Other researchers found that truck rates for farm goods exempt from ICC regulation were lower (on a ton-mile basis) than rates for goods subject to ICC regulations. Perhaps the crowning blow was a 1966 article by George

Hilton in the *Journal of Law and Economics*, which flatly concluded that even railroad regulation was an inappropriate response to the conditions in the late 1880s that brought it forth.

Timing, of course, is everything. When the broad scholarly consensus on the desirability of deregulation was reached during the inflation-plagued 1970s, politicians were already on the lookout for ways to fight inflation. They were happy to be handed clear evidence of how trucking and airline deregulation would simultaneously do that and benefit their constituents. Political scientists Martha Derthick and Paul Quirk argue in a 1985 Brookings book, *The Politics of Deregulation*, that deregulation would never have occurred if economists had not generally supported it through research and participated actively in policy debates.

Railroads, unlike trucking and airlines, were deregulated to keep the industry alive and in the private sector. By the 1970s, several major bankruptcies had already forced the government to take over part of the railroad industry by creating Conrail, and some policymakers feared that the entire industry would have to be nationalized. The 1973 report to the Council of Economic Advisers by the Task Force on Railroad Productivity, chaired by John R. Meyer, showed that regulation was inhibiting rail profitability and that the industry needed much greater pricing and operating freedom to avoid more bankruptcies. That the railroad industry, unlike the airline and trucking industries, supported deregulation also made it politically attractive.

Experience with Deregulation

Full deregulation did not happen overnight in any sector. Cautious regulatory agencies tried a variety of experiments and partial deregulatory actions, including CAB liberalization of airline entry and discount fare experiments during the mid-1970s and ICC liberalization of trucking and railroad rates (and railroad contracting with shippers) during the late 1970s. Congress followed with the Airline Deregulation Act of 1978, the Motor Carrier Reform Act of 1980, and

the Staggers Rail Act of 1980. Airline fares, entry, and exit were completely deregulated by 1983; trucking entry and interstate rates were, in practice, completely deregulated in 1980 (intrastate rates in 1994); railroads and shippers were free to set contracts in 1980.

Now, some 20 years later, the results of the deregulation experiments are in. For the most part, deregulation has worked the same way in each industry—and even better than expected. (For a comprehensive summary, see my chapter with Steven A. Morrison in a new Brookings book, *Essays in Transportation Economics and Policy: A Handbook in Honor of John R. Meyer*.) Eliminating entry barriers stimulated competition from both incumbent firms and new entrants. Intensified competition spurred innovations in marketing, operations, technology, and governance that enabled firms to become more efficient, improve their service quality, introduce new services, and become more responsive to consumers' preferences. The railroad industry got back on its feet, becoming much more profitable than it had been under regulation. But in the end, consumers gained the most.

Air travelers, enjoying a 33 percent decline in real average fares, as well as greater service frequency, have reaped annual net benefits of nearly \$20 billion (1996 dollars). Truck and rail shippers' annual benefits—primarily a 35–75 percent decline in real average rates and faster and more reliable service—amount to nearly \$30 billion. And these benefits have been achieved with continued improvements in safety.

Who lost from deregulation? Labor's experience was mixed. Truck drivers' wages fell, but rail and airline workers' wages held firm on average. Rail employment fell, but airline and trucking employment rose. For the most part, labor opposed deregulation—rightly for its own interest—but its losses are at most a small fraction of consumers' gains. As noted, rail profits increased and airline profits, though volatile, on average also rose, while truckers' profits declined. Probably the most vocal critics of deregulation are the minority of travelers and shippers who, often temporar-

ily and for idiosyncratic reasons, face very high prices and receive poor service. To be sure, long-distance air travelers on busy routes have benefited more than short-distance travelers on less-traveled routes, and large rail and truck shippers have gained more than their small counterparts. But the unequal distribution of benefits generally has had a rational basis. For example, roughly 90 percent of the difference between the gains of air travelers on busy routes and those on less-traveled routes is attributable to the higher costs of serving the latter routes, where smaller planes have a higher cost per seat-mile and fly with a smaller share of their seats filled.

The central point here is what deregulation's accomplishments teach us about government failure in transportation. Deregulation succeeded because firms were allowed and encouraged to respond to market forces by becoming more efficient and innovative. The intensity of competition unleashed among incumbent carriers and new entrants in each industry was unexpected. Other surprises included airlines' accelerated development of hub-and-spoke route structures to increase flight frequency; railroads' use of combined train-truck systems and double stack trains to improve service; and truckers' development of high-service megacarriers that even attracted business from shippers accustomed to providing their own trucking service. The problem in intercity transportation was not market failure but government failure. By suppressing competition, regulation had suppressed innovation and hurt consumers in ways that could be fully revealed only by deregulation.

MORE EVIDENCE OF GOVERNMENT FAILURE

Scholars have also developed evidence of government failure in regulating international transportation and taxis, providing urban transit and intercity rail passenger transportation, managing roads and airports, addressing transportation spillovers, and investing in transportation R&D. Although this evidence argues for additional deregulation or privatization that would enable the

SAY WHAT?

Transportation regulatory policy has baffled economists by consistently undermining the very public interest it was supposed to promote. One of the best examples of regulatory failure is its suppression of innovation in the railroad industry. As described by Robert Gallamore in his chapter in *Essays in Transportation Economics and Policy*, during the early 1960s railroads were exploring ways to develop more specialized freight cars to lower operating expenses. To exploit the innovation, a railroad might need to induce volume by lowering rates for the intended traffic. But when Southern Railway tried to use incentive pricing to introduce "Big John" aluminum grain cars, the Interstate Commerce Commission disallowed the rate for violating minimum rate regulations—thus protecting barge operators and other railroads while delaying innovation in an industry that sorely needed it.

Even a deregulated industry is not safe from regulation's pernicious effects. The Department of Transportation, for example, claims to want more competition in the deregulated airline industry, but the cumulative actions of its own agency, the Federal Aviation Administration, are restricting competition. FAA perimeter rules prohibit long-distance flights to or from Washington's Reagan National and New York's La Guardia airports. Slot controls limit the number of take-offs and landings per hour at La Guardia, National, Kennedy, and Chicago O'Hare. The FAA's inefficient and outdated technology prevents carriers from expanding their operations because it constrains airport and air space capacity. And by suspending ValuJet after initially defending it in the wake of a 1996 crash in the Florida Everglades, the FAA appeased the media but set back the reputation of all start-up carriers. With allies like that, who needs enemies?

private sector to improve transportation efficiency, policymakers have largely resisted change that would fully expose their failures in these areas.

International Transportation

Washington intervened in international air travel and ocean shipping several decades ago, not because of market failure but because of international disputes. The result, however, has been the same: government failure.

Today bilateral government treaties control air service between the United States and a foreign country. In most cases, these treaties restrict carriers' freedom to set fares and service frequency. Fares are roughly 30 percent higher than they would be in a deregulated market—even higher in more heavily regulated Asian-U.S. markets—and service frequency has been curtailed. Federal regulations also prevent foreign carriers from serving U.S. domestic routes. Although some U.S. officials advocate so-called Open Skies agreements that let market forces determine international fares and service, few support opening the domestic market to foreign carriers. Government negotiators are sensitive to U.S. carriers' complaints that foreign carriers are subsidized by their home governments and that the huge U.S. market offers foreign carriers more potential passengers than foreign markets offer U.S. carriers.

Unable to serve more markets abroad, U.S. air carriers have increased their presence there by entering into marketing alliances with and buying partial ownership of foreign carriers. U.S. carriers whose foreign partners have signed Open Skies agreements acquire antitrust immunity, which, of course, undercuts the competition encouraged by Open Skies.

American consumers would benefit if carriers focused solely on improving the quality and efficiency of their international operations. But the remaining regulatory regime encourages carriers to engage in repeated games with the government to maximize access to foreign routes while fending off competition.

In ocean shipping, rates and capacity are jointly determined by carriers themselves in government-sanctioned cartels, called "conferences." (A few smaller independent carriers choose to set rates outside the conference proceedings but must file them with the Federal Maritime Commission.) Rates are more than 20 percent higher than they would be in a competitive market, and service has been temporarily halted to some U.S. ports. As in international air transport, U.S. carriers have used the regulatory arena to seek protection from competitors while expanding their markets through global alliances. Government restricts operations in other ways, too. U.S. ocean carriers face curtailed competition from international air cargo because the latter is governed by bilateral treaties. And the 1920 Jones Act requires domestic shippers of waterborne freight to use U.S. carriers. Even in the post-NAFTA era, Canadian and Mexican carriers cannot move freight between U.S. ports.

Taxis

Closer to home, taxi fares and entry are subject to regulation by state or local governments in most urban areas. It appears that taxis were originally brought under regulation in major cities during the Depression simply to limit the number of licensed operators and ensure minimum profitability. But taxis are not natural monopolies, so, as in the case for trucks, regulation has primarily protected them from competition rather than benefiting consumers. For example, taxis often use the regulatory process to keep vans and limousines from serving airports. Deregulating taxis is not without controversy, however. Roughly 20 U.S. cities have tried it; some have seen fares fall and service improve; others have seen the opposite. Taxi deregulation is most likely to succeed as part of a broader strategy to stimulate competition in all modes of urban transport. Unfortunately, taxi's main competitor, urban transit, is provided by government.



BAD RAIL TIMING. Transit's inefficiencies are well known, but they can appear even worse because of bad timing. While this paper was being written, the Washington, D.C., Metrorail's electronic relay system experienced several malfunctions that forced Metro to switch to manual operations. These operations, in turn, led to several breakdowns during cherry blossom season, a peak period for Metro ridership because of an influx of tourists. The widespread Metro bashing that followed coincidentally occurred when the president and a vice-president of the company that manufactured Metro's electronic relays were sentenced for taking kickbacks from a subcontractor—for work done on other rail systems.

Urban Transit

Fifty years ago most urban transit was privately provided. During the early 1960s, with the financial condition of private transit companies deteriorating badly and with big city mayors arguing that subsidizing urban transit would be more cost-effective than building highways, Congress agreed to help cities buy their transit companies. Federal operating subsidies followed in the 1970s. Today, most operating assistance comes from state and local governments while Washington shoulders most capital investment.

But despite huge federal, state, and local subsidies, transit's share of all trips in large urban areas has fallen from more than 20 percent in 1960 to less than 10 percent today. And transit's high share of empty seats attests to its inefficient operations. In the mid-1990s rail filled roughly 18 percent of its seats with paying customers, buses roughly 14 percent.

Transit deficits are a serious drain on the public purse. By 1995, the U.S. pub-

lic transit operating deficit approached \$9 billion annually. Continuing capital investments swelled this deficit further. And here, as everywhere in transportation, government involvement portends better things for special interests than for travelers. It has been estimated that as much as 75 percent of federal spending on mass transit goes to transit workers (as above-market wages) or to suppliers of transit capital equipment (as profits and interest). Just 25 percent goes to improve service and reduce fares. Deficits can be economically justified if they are less than the benefits provided by the subsidized service. But in our 1998 Brookings book, *Alternate Route: Toward Efficient Urban Transportation*, Chad Shirley and I found that the benefits provided by bus to urban travelers in the United States were well below its subsidies and that the benefits provided by rail just equaled its subsidies.

One reason for the public transit deficits is that policymakers set fares far below the cost of service. Shirley and I

showed that an efficient policy—charging travelers for the cost of their trips and sharply curtailing service to the point where the added benefits equaled the added costs—would eliminate these deficits and enable transit operations to produce positive social benefits.

A second reason for the deficits is that public bus and rail companies fail to keep down costs. The large share of empty bus and subway seats is one indicator that costs are too high. Others are excessive wages (the typical Washington, D.C., Metrobus driver, for example, gets paid twice as much as drivers for the handful of private bus companies in the D.C. area) and declining productivity. According to Charles Lave, in a 1991 paper in *Transportation Planning and Technology*, transit productivity has fallen 40 percent since the public takeovers in the mid-1960s.

When intercity deregulation revived air, rail, and truck competition, carriers adjusted operations and developed new services to respond to customer prefer-

ences. But transit companies, not particularly concerned about competition, appear heedless to travelers' preferences. Their high share of empty seats reflects not only operating inefficiencies but also insufficient demand for current service even at subsidized prices. Bus and rail operations have generally failed to respond to socioeconomic and demographic changes that offer more ridership. They have not, for example, expanded service from inner cities to suburban areas where job opportunities are growing. And they have been painfully slow to introduce new technologies, such as real-time, demand-responsive services, or minibus operations that could benefit travelers.

It might be possible to overlook all these inefficiencies if the value of transit's service to the elderly and poor exceeded their financial contribution to transit. But it probably doesn't. According to recent evidence, the mobility of the elderly depends little on public transit. And not only has public transit failed to connect lower-income inner-city residents with new jobs in the suburbs, the new routes it has created mainly serve well-heeled commuting professionals heading toward the central business district—and are financed by taxes that fall disproportionately on the poor. With the average annual household income of bus commuters approaching \$40,000 and that of rail commuters approaching \$50,000, the poor are hardly transit's primary beneficiaries. Indeed, urban transit's financing and service inequities are probably one of government's least recognized failures.

Intercity Passenger Rail

Spurred by the 1970 bankruptcy of Penn Central, Congress created the National Railroad Passenger Corporation as a for-profit, quasi-public enterprise to provide intercity rail passenger service. Amtrak, as the corporation has come to be known, has always relied on federal subsidies to defray operating and capital expenses. In a 1990 article in the *Journal of Law and Economics*, Steven A. Morrison found that Amtrak's value to travelers falls

short of its subsidies on almost all routes except those in the well-traveled Northeast corridor.

Unlike deregulated rail freight carriers, which improved efficiency by abandoning unprofitable routes, Amtrak rarely abandons even socially undesirable ones. Amtrak is hoping to spur rail travel by investing in faster trains, not only in the Northeast corridor but nationwide, but its low ridership in most parts of the country makes large social returns on these investments unlikely.

Infrastructure Mismanagement

At an estimated value of roughly a trillion dollars, transportation infrastructure is America's largest civilian public investment. Federal, state, and local governments share responsibility for financing, building, and maintaining the nation's roads, bridges, airports, and ports. Their huge investment has been a boon to travelers and shippers, but waste and deteriorating quality are today evident everywhere.

The heart of the problem, as with public transit, is a mismatch between prices and costs. The costs of road use include congestion, which is caused by all types of vehicles, and road damage and bridge wear, which are caused by trucks only. The gasoline tax is used as a rough charge for all those costs but in fact bears little relationship to them. Costs could be covered much more effectively by charging users for the particular costs they incur. Congestion costs, for example, depend on the time of day motorists travel and the roads they use. Thus, motorists should pay a congestion toll—assessed electronically to avoid long lines—based on the cost of the delay they impose on others. Road damage depends on a truck's weight per axle (the more axles a truck has for a given load, the less pavement damage) and should be covered by a user charge per mile based on axle weight. Bridge wear, which depends solely on vehicle weight, should be covered by a user charge based on weight.

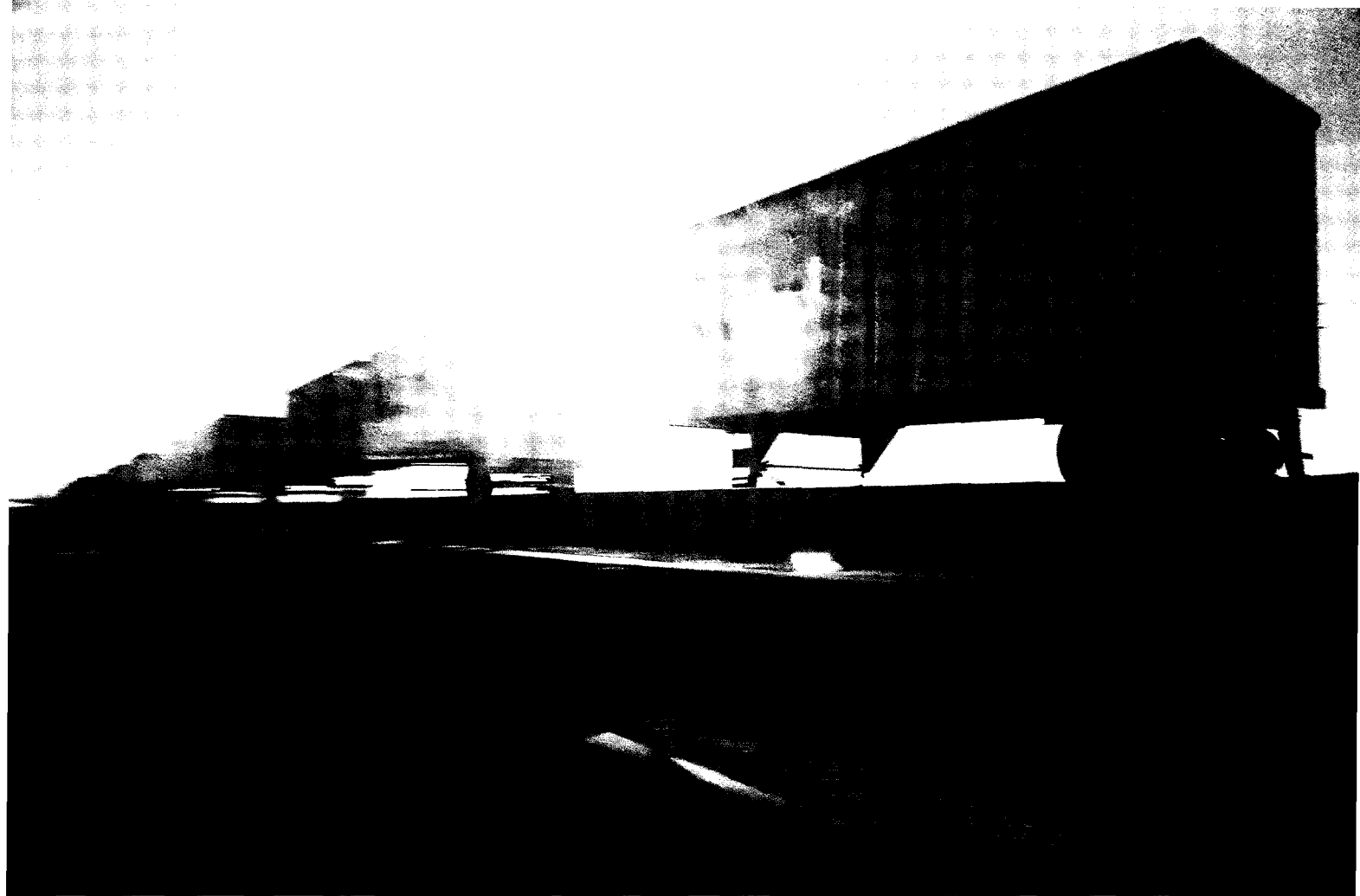
The same disjunction between prices and costs affects airports and ports. Airport landing fees are based on an aircraft's weight: a commercial jumbo jet

pays considerably more to land during a given hour than a small private plane. But the principal cost of an aircraft take-off or landing is the delay it causes other aircraft, which depends on the time of day it happens and on the airport's capacity. (Generally, the delay from a takeoff or landing by a small private plane is roughly the same as that from a takeoff or landing by a commercial jet.) All aircraft should pay an efficient take-off and landing congestion toll based on the cost of the delay they impose on other aircraft. In the case of ports, user fees are generally held below the costs of servicing a vessel to encourage greater port use. With less than 40 percent of their total financing coming from revenues, ports require large government subsidies, which could be cut substantially by cost-based charges.

Besides being mispriced, roads, airports, and ports have been incorrectly built. Road pavements, recent research has discovered, are too thin. Thicker pavement would hold up better under heavy truck use and require far less maintenance. And airports have been underbuilt. Optimal investment calls for many more runways at congested airports or, when this is not feasible, the use of capacity-enhancing technology, such as ground-positioning satellites, to help controllers manage traffic flow more effectively. Port facilities, by contrast, generally suffer from excess capacity, and much port capital is outdated.

Replacing current pricing of and investment in roads, airports, and ports with optimal pricing and investment would speed motorists' and air travelers' trips, lower highway maintenance costs and aircraft operating costs, and eliminate port subsidies. Total annual benefits would approach \$30 billion (for details see my 1991 article in the *Journal of Economic Perspectives*).

Government management of new infrastructure investments is also a problem. Although private managers are free to choose the contractor with the best combination of quality and cost, public agencies must choose the lowest-cost bidder. To prevent contractors from substituting inferior materials and construction techniques, public agencies write



minutely detailed specifications, thus encouraging contractors to adhere to the letter of the contract rather than to seek higher-quality, efficient alternatives. And because the government cannot always keep up with the latest technologies, some infrastructure investments need upgrading almost as soon as they are complete. Legislatures tend to encourage inefficiency by ignoring cost-benefit analysis when authorizing spending. When they do use such analysis, they often overestimate future demand and underestimate costs. Federal legislators load transportation bills with demonstration or pork barrel projects to ensure passage (the 1998 Transportation Equity Act for the 21st Century is larded with some \$9 billion of pork). State and city officials tend to prefer investments that entail a large federal contribution over those that could yield greater social benefits. In fact, the highway laws of several states direct officials to select projects to maximize the use of federal funds.

In short, government's failure to make the most efficient use of its transportation infrastructure investment and to get the highest return from additions to it has substantially elevated the nation's transportation bill.

Transportation Spillovers

One form of market failure addressed by government is socially costly spillovers such as congestion, noise, pollution, and accidents. How well has government handled these problems?

Let's start with congestion. Though government has (sometimes feverishly) built new roads (which almost immediately fill up with cars) and overspent on mass transit partly to lure people from their cars, it has not implemented *efficient* policies (such as tolls) to reduce congestion. Left to their own devices, urban commuters have avoided congestion by living closer to work, using (heavily subsidized) public transit, commuting during off-peak travel periods, and so on.

The federal government *has* addressed noise, pollution, and safety, but often without considering how the market responds to such transportation spillovers and how to maximize social benefits. For example, aircraft noise standards set by the Federal Aviation Administration have done more economic harm than good. In a forthcoming *Journal of Law and Economics* paper, Steven A. Morrison, Tara Watson, and I show that the noise standards, which forced airlines to replace planes prematurely, generated far more costs to airlines and travelers than benefits to homeowners. But even an optimal noise policy—one that relies on noise taxes or surcharges to encourage airlines to find their own ways to lower noise levels—would produce very small benefits, in part because the cost to airlines of lowering noise is still greater than the benefit to those homeowners who have a high enough tolerance for noise to be willing to live closer to a flight path.

Pollution is one area where govern-

ment regulation has produced benefits, but even there, government could have done better. Instead of saddling auto manufacturers and oil companies with costly technology and product mandates, government could have achieved comparable results at less cost with a pollution tax that encouraged people both to drive less and to buy cars that emit less pollution.

Corporate Average Fuel Economy standards were originally set by Washington during the early 1970s to increase the fuel economy of new cars and potentially reduce pollution. In a 1992 article in the *Journal of Economic Perspectives*, Robert Crandall concluded that the standards often failed to improve on the market's ability to induce consumers to purchase fuel efficient cars. They also produced negative net benefits because they raised vehicle prices and created unintended costs—smaller, less safe cars that were driven more.

Buses and electric vehicles have also been touted as ways to reduce auto emissions. But buses, as Chad Shirley and I showed in *Alternate Route*, have done little to improve urban air quality because of their low ridership and their diesel particulate emissions, which are more harmful than auto emissions. And electric vehicles, as noted by Robert Leone in his chapter in *Essays in Transportation Economics and Policy*, fail a social cost-benefit test because current technology is costly and has little impact on the environment. The vehicles themselves may have no harmful emissions, but the power plants that generate their electricity do, and discarded electric vehicle batteries may also damage the environment.

How about transportation safety? Ian Savage concludes, in his chapter in *Essays in Transportation Economics and*

Policy, that the transportation product market may, in theory, fall short on safety. But has government policy helped address the problem?

Automobiles' earliest safety features—headlights, brakelights, emergency brakes, windshields, and headlight dimmers—were introduced by automakers without any government pressure. Over the years autos have become increasingly safe because of improved visibility, handling, brakes, reliability, and body structures.

Automakers have needed to be convinced that their (often substantial) investments in vehicle safety will be recouped—that consumers value and are thus willing to pay for them. But once convinced, they have made one type of safety investment after another.

Government, however, has felt that it could improve on the market's provision of automobile safety. In the late 1960s, the National Highway and Traffic Safety Administration required cars to be equipped with seat belts, an energy-absorbing steering column, penetration-resistant windshield, padded instrument panel, and dual braking systems, even though

market acceptance of these safety items, with the possible exception of seat belts, had been negligible. In a classic 1975 paper in the *Journal of Political Economy*, Sam Peltzman found that the regulations' benefit to vehicle occupants had been completely offset by drivers taking more risks that increased pedestrian deaths and nonfatal accidents. Although subsequent research has debated Peltzman's finding, few analysts question the existence of some offset. Nor have researchers been able to show that the market would not have intro-

duced these safety features once motorists were willing to pay for them.

In a 1995 article in the *Journal of Law and Economics*, Fred Mannering and I concluded that automakers began widely offering air bags not because of government action, but because consumers were finally willing to pay for their (less costly) installation and more reliable deployment. Supporters of government regulation of auto safety often argue that consumers have insufficient information about the benefits of safety devices. But Mannering and I found that consumers followed information about experiences with air bags (most spectacularly, the head-on collision near Culpeper, Virginia, of two air bag-equipped Chryslers whose drivers walked away unhurt) as it spread through the media and friends and were therefore increasingly willing to pay for air bags. Once the market accepted air bags, however, government intervened to set a deployment standard for all air bags, thus delaying improvements in technology.

Although the public has expressed concern that deregulation of airlines, railroads, and trucks might cause carriers to sacrifice safety for short-term profits, intercity carriers have in fact become much safer over the past few decades. Government's role in promoting that safety, however, is debatable. The National Civil Aviation Review Commission, for example, has called for the airline industry to increase self-regulation instead of relying so heavily on federal enforcement and safety rules. The railroad industry maintains that government regulations have had little to do with its improved safety record. And police crackdowns on truckers' driving violations have been much more effective than any safety regulations.

Research and Development

Research and development may be prohibitively expensive, and its benefits insufficient, for the private sector to carry out. Government involvement here is justified on the grounds that the benefits of the R&D investment it undertakes—because the private sector cannot or will not—spill over into large parts of the economy.



But the history of government R&D in transportation is not encouraging. During the 1960s, Washington spent nearly a billion dollars to jump-start development of a supersonic commercial airplane. When the project began, the aircraft industry was expected to bear 25 percent of the costs; in fact its share was only 10 percent. Facing mounting technical problems, rising costs, and opposition by environmentalists and local airport authorities, the federal government eventually abandoned the program. Left on its own, the private sector went on to invest successfully in new fleets of efficient wide-bodied and short-haul jets, but not in supersonic planes.

Now Washington has made \$1 billion available to promote development of high-speed ground transport, including standard rail retrofitted for higher speeds, new high-speed rail, and magnetic levitation (Maglev) transport. States are also getting into the act. California, Texas, and Florida, among others, are considering high-speed rail lines to link their major cities. A congressionally mandated cost-benefit study, however, found that the net benefits from federal support of high-speed ground transportation were negative. And with construction costs of some \$30 billion, the proposed bullet train between San Diego and northern California would also be hard pressed to generate positive net benefits. Whether the public would be willing to underwrite these projects is highly uncertain.

Washington has also spent more than \$500 million—and has committed another \$1.3 billion over the next five years—to develop an intelligent transportation system that uses sophisticated information technology to navigate and even operate vehicles, thus improving both automobile safety and congestion. Conservative estimates are that fully developing a national system could ultimately cost the government more than \$100 billion. Without compelling and persuasive benefit estimates, it is hard to justify this sort of megaspending when there are far less costly ways to improve safety and reduce congestion.

CAUSES OF GOVERNMENT FAILURE

Many social scientists, including some Nobel Prize winners, have developed general theories of government to explain why certain policies are implemented and others are not. Without drawing completely on any one theory, the simplest answer to why government repeatedly pursues inefficient transportation policies is that policymakers—appropriately—respond more to political forces than to market forces. Transportation policy has thus become a giant grab bag whose benefits are available to various vested interests—some just get more than others—at the expense of a more efficient transportation system that could save the public at large billions of dollars. And the costs of government failures have soared because the grab bag continues to grow.

To be sure, intercity transportation deregulation prevailed over the objections of the trucking and airline industries and of transportation labor. (Policymakers also tinkered with deregulation—unnecessarily, as it turned out—to appease air travelers from small communities, who feared they would lose service, and rail shippers who might be captive to one railroad and face exorbitant rates.) But intercity deregulation is a rare case where a more efficient transportation policy overcame the resistance of entrenched interests.

The rest of the transportation system continues to channel the public's money to vested interests. Remaining regulatory regimes raise the profits of airlines, ocean carriers, ship builders, and taxi owners; urban transit policy rewards transit managers and labor as well as suppliers of capital while subsidizing transit patrons; infrastructure policy subsidizes truckers, aviators, motorists, and mariners; and government R&D spending benefits consultants, engineering companies, and so on. Social regulations confer benefits on and exact costs from particular groups in disproportionate measure. Noise regulation benefits homeowners but taxes air travelers and airlines excessively; emissions and safety regulations (partly) mollify environmen-

talists and safety advocates and benefit some of the public but cost automakers and motorists more than necessary.

Can the government shift its habitual focus from nurturing these political interests to improving transportation policy? In a 1998 *Journal of Economic Perspectives* article Joseph Stiglitz asserted that his effort, as chairman of the Council of Economic Advisers, to institute congestion pricing at airports failed because general aviation (owners of corporate jets and small planes) lobbied against reform and because the government was unable to make a credible commitment to compensate them for the higher landing fees they would have to pay. Perhaps. But I would argue that the government *could* credibly commit to building reliever airports to accommodate general aviation without sharply raising their landing fees. The real stumbling block is that the flying public's appreciation of efficient takeoff and landing fees would be mild at best.

Policymakers are capable of designing mechanisms to compensate subsidized interests (as they did to gain passage of intercity deregulation), but they have no interest in doing so unless the political payoffs are large. And it is extremely difficult for the government to implement efficient reforms. Consider airport congestion fees. To determine efficient charges, government would have to get accurate estimates of the value of passengers' travel time and of how long an aircraft's take-off and landing delays other aircraft (to name just a few variables). Charges would then have to be carefully assessed for thousands of daily operations at a given airport and varied in accordance with traffic flows. In the longer run, and even more challenging, government would be expected to reduce the delay caused by aircraft operations—and thus lower congestion fees—by building new runways and implementing technological advances to expand capacity.

In my view, government simply lacks the appropriate economic incentives and faces too many practical and political constraints on its use of labor,

acquisition of technology, and so on to implement even rough approximations of efficient airport charges. (Imagine the battles it would take just to reach a consensus on an estimate for the value of passengers' time). The solution is for government officials to approve the policy's goal and then allow the private sector to achieve it—in this case, by privatizing airports.

Excellent precedents exist for this approach. For example, during the 1970s deregulation debates Congress recognized that regulation had generally elevated air fares above efficient levels. But instead of giving the Civil Aeronautics Board a detailed set of guidelines on how to adjust fares to make them more efficient, it deregulated the airline industry and allowed the private sector to solve the problem.

Elected officials do have an incentive to keep the costs of their failures as low as possible. Why completely waste resources that could be given to some interest in return for political support? Nonetheless, the inefficiencies that government has created in the transportation sector are large and will persist as long as government continues to provide service, regulate carriers, and manage the infrastructure. We can reduce them only if government cedes to the private sector the responsibility for most of its current tasks.

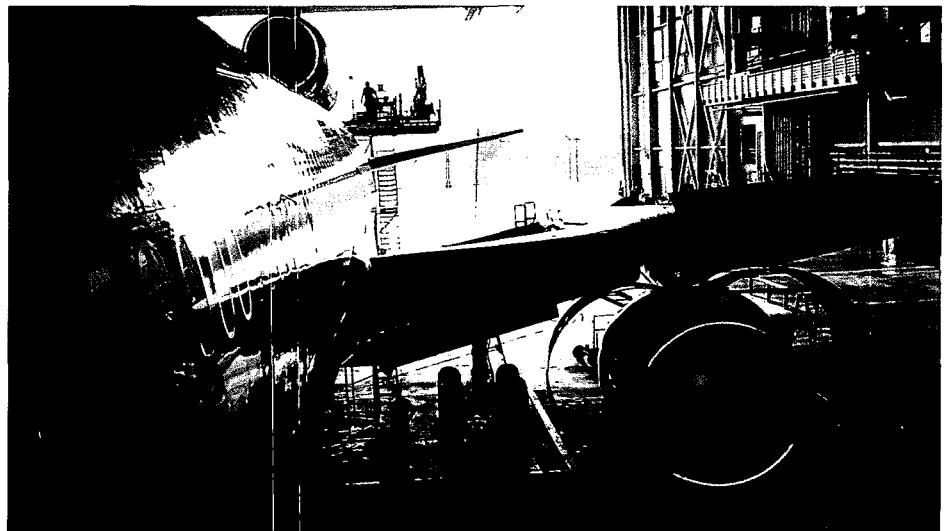
IMPROVING PERFORMANCE VIA THE PRIVATE SECTOR

It is unreasonable to expect government intervention in an imperfect market to produce perfectly efficient results. But government failures in transportation have clearly imposed costs that go beyond acceptable imprecisions in pursuit of correcting (possible) market failures. Similarly, it is unreasonable to expect that allowing the private sector a freer hand in transportation will produce perfectly efficient outcomes. But it is reasonable to expect private markets to respond effectively to potential market failures and to expect that the cost of their imperfections will be considerably less than the cost of government failure.

Domestic Intercity and International Transportation

Early critics of airline and railroad deregulation maintained that small airline and railroad markets could not support competition. In fact, air travelers to and from small communities have been able to choose among carriers that offer service with smaller (regional) jets, while rail shippers who appear captive to one railroad have the option of using railroads that have formed a small system or using another major railroad with trackage rights over the "monopoly" carrier's track. Rail users can also benefit from source competition—for example, Alabama utilities that face rate increases on coal shipped from Colorado can switch to coal from Kentucky if they can access a different railroad—and from product competition—for example, utilities that face rate increases on natural gas can shift to coal or oil if their technology permits such substitution. To

ability to solve imperfections that arise from time to time, some Washington officials continue to bend to lobbying efforts by particular interests. The Department of Transportation drew up competition guidelines partly in response to claims by the Air Carrier Association of America, the small, low-fare carriers' lobbying association, that some large airlines have set predatory prices. Travelers' complaints of shoddy service spurred Congress to consider a "passengers' bill of rights" that, among other things, increases compensation to passengers who are denied boarding. But carriers' alleged predatory behavior has had little effect on travelers' welfare, and overbooking is a long-standing industry practice, the threatened penalty for which will only increase costs and fares. The market has been and continues to be the best way to promote competition and protect travelers against carrier abuses.



be sure, a minority of air travelers and rail shippers have limited competitive options and face high prices—even higher than those under regulation. But this situation is often temporary. Air carriers, such as Southwest, do enter routes dominated by one carrier, and shippers can negotiate lower rates and better service from a major railroad by, for example, using a combined truck-rail operation that gives them access to a different railroad as a bargaining chip.

Despite deregulation's widespread and ongoing benefits and the market's

Rather than meddling in a deregulated industry, federal policymakers should be more aggressive in seeking to extend the benefits of domestic deregulation to international airline markets and should also open up the domestic air transportation market to foreign competitors. The new Ocean Shipping Reform Act, which allows importers and exporters to negotiate individual, confidential contracts with ocean shipping lines, appears to be a step in the right direction. But further reform is needed because shipping lines retain their immunity from

federal antitrust laws and can still set their rates collectively.

Urban Transit and Taxis

It is true that the federal government got involved in urban transit during the 1960s because private transit failed. But subsequent research has pointed out that private bus operations had been seriously hampered by government regulation. Today, privatization is the only realistic hope for paring the huge inefficiencies accumulated in urban transit under public management.

Just how would privatization make a difference? Private bus and rail companies, competing vigorously with each other and the private auto, would set prices and service to maximize profits. Chad Shirley and I found that the economic effects of such competition are remarkably similar to the effects of efficient pricing and service. Society would gain from eliminating transit deficits, and the traveling public would gain from more efficient, responsive, and innovative services. As in intercity deregulation, new entrants, such as jitneys and minibuses, would be key. Taxis should also be deregulated as part of a broader strategy to stimulate competition in urban transport. No longer enjoying a secure niche between the private car and the city bus or rail service, taxis would be forced, for example, to compete with vans that operate like taxis and offer links with rail and bus operations. The increased competition and coordination in the new urban transit system should lower taxi fares, improve service quality, and enable taxi operations to impose some competitive pressure on transit.

Critics of privatizing mass transit often object that its benefits would be achieved only by redistributing income from low- or fixed-income travelers to wealthier citizens. But, as noted, the poor and elderly do not especially benefit from the current system of financing and providing mass transit. A compelling example of the potential benefits of privatization for low-income workers is the dollar-a-ride service in the New York City borough of Queens. Queens Van Plan, a private company

serving mostly low- to middle-income minority workers whose neighborhoods are neglected by public mass transit, provides an essential service and operates at a profit. Current regulations, however, prevent the company from serving other low-income areas of New York. Under a privatized system, Queens Van Plan and similar entrants would be free to expand where the market demanded.

Federal policymakers should use grants to encourage cities to run privatization experiments. The experiments, of course, would not be problem free. As in intercity deregulation, service providers and travelers would need time to adjust to the new competitive order. And although privatization is unlikely to cost low-income travelers more in the long run, short-term assurances—perhaps in the form of transportation vouchers—could help build support for the experiments. But once experiments begin, policymakers must allow competitive markets to evolve and not micromanage the transition.

Infrastructure

Although it would undoubtedly be a challenge to enable the private sector to curb the huge pricing, investment, and production inefficiencies in public infrastructure, it is possible to sketch how it could be done. Many economists, myself included, have resisted private sector involvement and held out hope, for example, that the public sector would institute highway congestion pricing. And there have been some promising signs, such as the new high occupancy toll (HOT) lanes in southern California and Houston, where solo drivers can pay a toll to use a less congested carpool lane, and the successful congestion pricing experiment on a private highway in California's Orange County. But a few HOT lanes and congestion tolls on a private highway are still light years from a widely adopted congestion pricing policy. And congestion pricing does not address the massive inefficiencies in building and maintaining roads and bridges. In the case of airports, Boston Logan did reduce congestion by increasing landing fees for general aviation, but Logan's price increase was found to be

discriminatory—landing fees for larger planes had been cut to keep the plan revenue neutral—and it had to be rescinded.

I have come to believe that infrastructure inefficiencies will persist unless managing authorities face some competitive discipline. The limited evidence bears me out: when private firms are hired to perform highway maintenance, collect tolls, and manage airports, cost savings total 20–30 percent. New Zealand is considering a bold first step, called commercialization, where the government turns its roads over to commercial road companies, which would be expected to charge for their use and earn a return on capital while being regulated as public utilities. Such a policy would be problematic in the United States, where government regulation of public utilities is renowned for creating inefficiencies. But pure privatization raises the fundamental problem of a lack of competitive options to curtail monopoly abuses. Could that problem be addressed? Suppose the government distributes roads to commercial companies, as in commercialization, aiming to allocate potentially competitive sections (for example, California's Highway 101 and Interstate 5) to different companies. Private companies would be free to establish their own investment and maintenance policies, but they would negotiate prices (long-term contracts) with private local and state organizations representing motorists, truckers, railroads, and private transit companies. Government transportation would also be represented by a bargaining organization. Thus public and private users *en masse* would be able to bring competitive discipline on prices, and private companies would have a financial incentive to minimize costs and provide high-quality service.

Although such a scheme may seem far-fetched, there is a growing reason for considering something like it. As noted, Washington has already spent roughly \$500 million and is committed to spending far more on exploratory plans for an intelligent transportation system, which if fully developed would ultimately cost hundreds of billions of

dollars. Such a system would call for much greater public management of highway travel and, if history is any guide, add substantially to infrastructure inefficiencies. Only the private sector has the incentive and ability to develop and hold down the costs of an intelligent transportation system and maximize its life- and time-saving capabilities. If Washington wants to move to a new era of highway transportation, it should give serious thought to allowing the private sector to own and manage the road system.

Similarly, the government should increase the private sector's presence in air travel by privatizing airports and air traffic control. As with private roads, private airports and air traffic control would negotiate user fees with commercial and general aviation. Facing competitive discipline from users and alternative facilities, private airports and air traffic control would have an incentive to minimize costs and provide high-quality and technologically up-to-date service such as "free flight," which enables pilots to choose their optimum flight patterns instead of being crammed into the limited number of FAA-defined air routes. More efficient use of airport and air space capacity would also enhance airline competition.

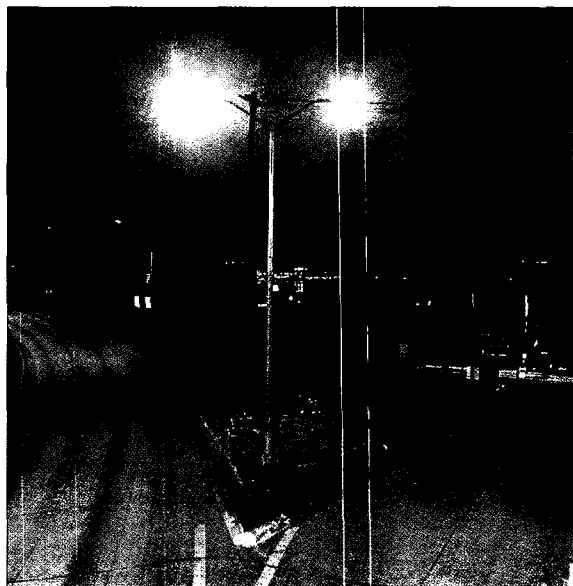
Privatizing roads and airports would also make it much easier to introduce technologically current aids to improve safety and to set efficient prices for transportation spillovers. Indeed, the substantial improvement in automobile safety should convince policymakers that their periodic regulatory interventions would have little value. As part of the privatization contract, road companies would be required to include a cost-based pollution tax and airports, a noise tax. Inefficient federal regulations to curb emissions and limit noise could then be rescinded.

Finally, the government should withdraw from the railroad business. Funds for high-speed rail and subsidies for Amtrak should be eliminated. Existing and new modes should be forced to meet

the market test. If high-speed rail is commercially viable, the private sector will pursue it. If the only way Amtrak can stay in business is by serving just the Northeast corridor, then it should be allowed to abandon service elsewhere.

WHAT WILL SPUR CHANGE?

The scholarly case for greater private sector involvement in transportation has been built slowly but broadly. In the 1950s, John Meyer and his research collaborators laid the intellectual foundation for deregulating intercity transportation. Nearly 50 years later and despite strong evidence, some policymakers still need to be convinced that deregulation has succeeded and can continue to succeed on its own. Subsequent research has



provided a basis for expanding the cause to deregulate international transportation and taxis and, more recently, to privatize transit and transportation infrastructure.

Based on the evidence reported here, annual benefits of some \$50 billion would be accrued from greater private sector involvement in transportation. But that figure greatly underestimates the potential gains for two reasons. First, it fails to account for ridding the system of transportation-related costs that are hard to quantify, such as bloated inventories and urban sprawl. Second, it does not include costs of government failure that become clear only after deregulation or privatization takes place.

Because policymakers benefit from business as usual, why would they consider fundamental changes in policy to pursue greater transportation efficiency? Intercity deregulation became politically attractive when the political benefits to policymakers from working in harness with carriers and labor were overwhelmed by the potential political gains from reducing inflation. Similarly, the probability of deregulating or privatizing other areas of transportation will increase if the prospect of major political gain becomes clear. Unfortunately, it probably won't in the near future. Despite the obvious benefits for consumers, international airline deregulation is moving slowly, especially because carriers from other countries are wary of competing with U.S. carriers. U.S. transit subsidies and infrastructure inefficiencies are large and growing, but recent successes in eliminating state and federal budget deficits have temporarily eased pressure to cut wasteful spending on transportation. In fact, recent federal legislation vastly increases support for transit, highways, and airports well into the next century.

Eventually, the political cost of sustaining large transportation inefficiencies will spur change, but policymakers must see the political payoff from reducing these inefficiencies. And while the current state of evidence strongly suggests that any inefficiencies resulting from further deregulation and privatization will not come close to the cost of government failure, there are clearly risks associated with these policies. Researchers can help ease policymakers' fears by continuing to show them the economic—and political—benefits of a more efficient U.S. transportation system. They can also demonstrate how these benefits can be achieved by deregulation and privatization and how technological change can facilitate competition—the key to the success of deregulation and privatization—in ways once unimaginable. Policymakers will not forgo the chance to increase the system's efficiency forever. ■

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